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Renewal Costs and Business Profits in Relation to Rising Prices

By John Bauer

Industrial management faces a grave danger during a period of rising prices in that the revenues or gross earnings show the full effect immediately, while many of the additional costs are more hidden and are not fully disclosed in the accounts as they are incurred, but finally cannot be avoided. This results for a time in an overstatement of profits and unjustified payment of dividends or withdrawal of earnings but in the end means waste of capital and loss of income. The prosperity of rising prices is usually unreal. People fool themselves with the greater number of dollars that they receive, while they do not count the full costs that ultimately must be paid, and they actually become poorer in the meanwhile.

I wish to discuss one particular cost which is being generally overlooked, but which, in the end, will have to be faced by all business and society at large—the allowance for depreciation or renewals of industrial plant. At best, this matter has been handled haphazardly in the past and has caused many business failures. But, at present, there is extraordinary danger, even to concerns which heretofore have made seemingly adequate provision for depreciation or renewals. Provisions for renewals of plant are commonly made in one of two ways, although, of course, other methods may be used: (1) charging to operating costs a systematic allowance for depreciation or, (2) charging to operation the original cost of property retired as renewals are made. The object of either method is to maintain out of earnings the investment in property, so that when any unit of plant or equipment has been withdrawn from service, its cost shall have been made good out of earnings and shall then be taken out of property account.

We shall not be concerned here with the technique of accounting, as to whether the one method or the other be used, nor with the relative advantages or disadvantages in actual practice. The point, however, should be clear that all recognized methods result

in charging to operating account the original cost of property retired. This policy, in view of the higher present level of prices, is wrong. If the present level continues, or is maintained to such extent that renewals will cost more than property retired, the recognized allowance for renewals is inadequate and should be raised in proportion to the higher prices.

The issue is whether as a principle of management and accounting, the charges to operation for renewals should result merely in keeping up the so-called investment in dollars and cents, and no more, or in actually maintaining the plant in its physical condition and capacity as a producing agent. The first is, of course, the generally accepted view, which is doubtless based on the assumption that prices are ordinarily constant and that the general level does not change. If prices were constant, both the investment in dollars and cents, as well as the physical plant, would be maintained out of earnings, by including in operating account only the original cost of the property retired. But if prices have risen, then, while this practice will maintain the so-called investment in terms of dollars, it will not keep up the physical condition and production of the plant. It will result in additions to capital account without enlarging the plant, or increasing its producing capacity. The question therefore arises, is the purpose of management merely to maintain investment in terms of dollars, and to show current costs and profits accordingly, or is it really to keep up the plant and equipment and to maintain the physical productivity of the property?

If the question and facts are once clearly understood, there can scarcely be a difference in opinion. The purpose of management certainly must be to maintain the physical plant, and to keep up production without drawing upon capital funds. If this be true, then, when the price level has risen, the charge to operation for renewals should not be the original cost of property retired, but the cost of new property which, in function and capacity, is required to replace the old. The point may be presented more clearly by concrete illustration.

Assume that a street railway company purchased 1,000 passenger cars at $5,000 each, that the cars have an average life of 20 years and that the company allows for depreciation $250.00 a year per car. On the average, therefore, by the time a car is

retired, the full original cost of $5,000 has been charged to operation and has been reserved from earnings. The original cost of $5,000 is then written off and the cost of all new cars is charged to capital account. So long, then, as prices remain unchanged, this policy is satisfactory; operating costs and capital account are properly stated. Suppose, however, that prices have doubled —then the renewal of every car that had cost $5,000 requires $10,000. But, if only $5,000 have been charged to operating costs and reserved from earnings, then simply to renew its property, without any improvements or additions, the company must pay $10,000 instead of the original cost of $5,000. Having kept from earnings only $5,000, it is compelled to make the additional expenditure out of capital funds derived from the sale of securities. When all the old cars have been renewed, the company will not have more or better cars, but will have doubled its original capital account, and will have twice the original bonds or other securities outstanding. While it will have maintained its investment in terms of dollars, it will have standing against property of the same physical character and capacity securities of $10,000,000 instead of $5,000,000. Merely to replace the cars, it had to borrow $5,000,000—an amount equal to the cost of the original equipment.

It may be argued in the above illustration that because of the change in prices, net earnings in the meanwhile would have doubled and would justify the additional obligation. Again, this is true in terms of dollars, but not in reality. Half of the earnings would be required as interest on the new bonds; the rest would be equal to the old earnings in dollars, but would constitute only half of the former purchasing power. The company would earn the same amount of money for its owners, but would turn over to them only half the former income in terms of everyday purchases.

This is the inevitable result of simply maintaining investment in terms of dollars and charging to operation only the original cost of property retired. This policy will not maintain the physical capital in the face of rising prices.

Operation should be charged with the expected cost of renewals, regardless of the original cost of property withdrawn from service.

In our illustration, $10,000 should have been charged to operation and reserved from earnings for each car, instead of the original cost of $5,000. This would have shown greater costs during the shift from one price level to another; for the time being it would have kept down profits to the proper measure, and in the end would have conserved the actual capital and income of the company. On the new price level, the 1,000 cars would be worth double the original investment and would earn twice as many dollars for the owners. But, in terms of purchasing power, taking into account the doubling of prices, they would be only equivalent to the original investment, both in the matter of capital and income.

In practice, unfortunately, the facts are not so simple as in our illustration. New cars are usually purchased without regard to retirement of old cars; likewise, old cars are withdrawn from service without immediate consideration to the purchase of new cars. Types of cars are constantly changing; cars purchased now are larger and, in many ways, fundamentally different from old cars acquired twenty years ago. Consequently, even though much higher prices are paid now than formerly for new cars, the effect upon operating costs is not immediate and is easily overlooked.

Nevertheless, the result is inevitable—following the established provision for renewals, the property is not physically maintained out of earnings, and the renewals are actually financed out of security issues. Merely measured in dollars, the investment and income are maintained, but, counting the decrease in the value of the dollar, capital and income are allowed to decline. In the meanwhile excessive profits are shown at the expense of real capital.

While our illustration is taken from the field of street railways, the point applies to factories of all sorts and to all industries where renewal of plant and equipment constitutes a large proportion of operating costs, and especially where the life of plant and equipment is of considerable duration. To the extent that the present high prices are permanent, or that prices will not return to the former level, operating costs are everywhere understated by an amount equal to the difference in the amortization of original cost of property retired and the cost of actual renewal. Understatement of operating costs means a corresponding under-

statement of profits and, except in case of very conservative management, excessive payment of dividends or withdrawal of earnings. The dividend payments then become private income and result in unjustified feeling of personal prosperity, and in excessive private expenditures for luxuries or services which are not justified by actual industrial conditions.

Let us return to street railways and public utilities in general. While in our illustration I assumed that rates had advanced in proportion to other prices, public utilities rates have not generally been increased in proportion to the advance in operating costs. With comparatively few exceptions, public utility companies never did make adequate allowance for depreciation or renewals, even before the sharp increases in prices in recent years. But, where they should have been making additional provisions, they have been actually cutting down still further, so as to keep costs within revenues. This, however, has been mere make-believe: in the end, these are costs that cannot be dodged; they will have to be paid in one way or another.

Street railway companies in particular have been in a difficult situation, where they have been held to a five-cent fare. They have been skimping even ordinary repairs, and in notable instances have understated even these actual costs in the income account, by drawing on reserves accumulated in previous years. While the situation as reported by the companies is serious, the ultimate condition when extensive renewals will have to be made will be very much worse. If the funds are then to be raised through rates, the increases will have to be so great as to be practically prohibitive. If they are to be raised through the issue of further securities, the companies would first have to be made solvent, and then the additional interest would have to be paid out of an increase in rates. Again, there would then be the practical difficulty of actually making the rates high enough to cover operating costs and the necessary return on investment. The truth is, not only that the properties are not being kept up out of earnings, but the dodging of present actual costs will add greatly to the difficulty of ultimately placing the business on a solvent basis.

The situation as to public utilities, however, especially as to the street railways, cannot be set right simply by making adequate allowances to operating expenses and then raising rates so as to

cover the costs and bring the necessary return on investment. In many instances, before increases in rates can justifiably be granted by public authority, many questions of franchises must first be settled, or existing contracts between municipalities and companies must be extensively revised, or other questions of amount of investment and right to return must first be judicially determined. In notable cases, although franchise and contract revisions will ultimately have to be made, reasonable adjustment will seriously affect existing financial interests and will therefore not become possible until all hope of getting higher rates, without concessions to the public, shall have been abandoned by the companies, or until the most safely intrenched interests shall otherwise clearly go down in financial ruin. Unfortunately, too, the public authorities are not in all cases simply honest, but are acting with unworthy political motives. In some instances, the struggle will be long drawn out, and in the meanwhile the properties will continue their deterioration. In the end, their deferred costs of maintenance are certain to fall on the public and will then bring home the realization that we have been living on capital and not on actually earned income. Present rate controversies are therefore particularly unfortunate, in that they keep the public from realizing now the costs that are actually being incurred in the service.

In regard to renewals of public utility properties, it may be argued that each generation of consumers should simply bear the costs of service at the time, and that in line with this view, the proper charge to operation is the actual cost of property consumed in service, not the renewal cost. If the latter is greater because of higher prices, the addition, it may be urged, is properly paid out of capital funds and thereafter its cost should be charged off to operation while the property is being consumed in service. In regulated industry, it may be conceded, wide discretion may properly be exercised in the distribution of costs to the public. A regulatory commission well may follow the policy that is thus defended. But, the ultimate financial facts cannot be dodged, that following this policy will relieve present consumers of costs that are due entirely to mere change in prices and will place upon future consumers not only the then greater amortization of property but also a greater interest burden on account of renewals financed out of capital funds. If prices have doubled, there will

then be a doubling of interest costs, as well as doubling of renewal charges. The better and sounder policy would be for present consumers to bear the double renewal costs so that the physical property would be maintained out of earnings; then while future consumers would continue bearing the greater renewal costs, they would not be burdened also with the higher interest charges.

If present rate-payers do not provide the additional renewal funds, they will be relieved from costs which really belong to the present, and will add accordingly to the costs imposed on future consumers. This is the point of this entire discussion. Costs cannot be avoided; but their showing can be deferred. The public should provide now for complete renewals of property, together with all other costs, whether in strictly private business or public utilities. If it does not make adequate provisions, it will overstate its present prosperity, will indulge in extravagant personal expenditures and in the end will find itself poorer because of the present showing of unearned profits.

The point may be urged that present high prices may be only temporary, and we may soon return to the pre-war level. This is true; but, also, we may go to much higher prices and stay there and be compelled to make renewals at the still greater costs. We do not know what the future will bring; but we may reasonably expect a long continuation of prices substantially higher than before the war. The sensible policy is to accept present prices as permanent and to count all costs accordingly. If, however, prices recede, there will then be time again to make reductions. But if prices go still higher, we should be prepared at every step to count the greater costs immediately. This practice in itself would prevent prices from going higher than is warranted by the fundamental economic conditions. The present showing of personal income would be substantially less; consequently there would be a considerably smaller demand for current consumption of goods and services, and there would be less motive for all sorts of profiteering enterprise.