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The Idea of Capitalization as Applied to Public Service Corporations

By John Bauer

As ordinarily used, the term *capitalization* signifies the par value of a corporation's stocks and bonds (or securities) outstanding. But this is not nearly so definite and simple a matter as it sounds and, when applied to public service corporations, there is a question whether the term does not assume a more or less special significance. The purpose of this discussion, therefore, is to consider the concept of capitalization particularly in reference to public utility corporations.

In general, capitalization in the case of a corporation may be considered analogous to the term capital as used in the accounting sense in the business of a single proprietor or a partnership. Thus capital may be defined as the proprietor's claim to or equity in the assets or property of the business. The amount appears as a credit balance, and it must not be confused with the assets or property which appear as debit items.* As accounts are ordinarily kept, the capital account is intended to show the owner's investment in the business, which is equal to the amount of cash or other funds put into the business either directly or through the reinvestment of earnings.

* It is easy to confuse capital as economists employ the term with its strict accounting significance. In the former sense capital signifies physical things of value, namely assets or property; while in the accounting sense it shows the proprietor's equity or interest in the assets. In the first sense capital would appear on the debit side of the balance sheet, while in its strict accounting sense it appears on the liability side.—J. B.

Now, in the case of a corporation, the stockholders are strictly the proprietors, and by analogy their investment would be the capital of the business. In law this would be expected to be equal at least to the par value of the capital stock issued. If then capitalization were to be used in the case of a corporation throughout as analogous to capital in a partnership it would signify the par value of the capital stock issued, plus all premiums on stock, also plus all surplus reserves accumulated out of income. Still, as ordinarily used, the term is not thought of as including premiums and surplus and reserves, but is considered as covering also the par value of bonds or so-called funded debt outstanding. Nevertheless there can be no doubt as to the analogy between capital of a single proprietor or partnership and the capitalization of a corporation. The explanation of this contradiction between the real significance of the term and its ordinary usage appears to be that while from a strictly legal standpoint the stockholders are the proprietors, still in reality we think of the bondholders no less than the stockholders as forming the corporation. The bondholders, of course, have a long-term interest in the property, and we therefore look upon all the permanent or long-term equities as investment and include them under capitalization. And while premiums and surplus and reserves should be included, and deductions should be made for discounts, par value is the more obvious thing, is constantly emphasized in legal and financial discussion and is therefore regarded par excellence as the capitalization. The fundamental notion, nevertheless, is investment, or proprietorship in the business; and strictly speaking that is the significance to which accountants must logically adhere.

If now we turn to public service corporations, we find there particularly that the legal view of the corporation has been extended and the change in effect has been accepted into law. The real nature of the public service corporation appears in the rate cases and in the control of return on investment. Our general theory, which is recognized in the law as interpreted, is that a corporation is entitled to a fair return on its property, which must be valued on a reasonable basis. While this idea has never been clearly set forth by any commission, the question that necessarily comes up

is what interests are considered as constituting the company whose return we are fixing. The answer can be readily discovered if we examine the general practice in rate cases. First an appraisal is made of all the fixed or more permanent property used in service and to this is added an amount for working capital. The latter is usually determined by taking the sum of the current assets connected with the business and deducting the current liabilities. The total valuation is considered the investment of the company, and the return allowed is based on the amount.*

It should be clear that what the process amounts to is that a valuation is placed on all the assets employed in connection with the service and from the amount a deduction is made equal to the current liabilities. The result is the company's investment. Now, why the deduction? Why not consider the investment equal to the sum of all the assets? The only answer is, though the fact has never been so stated, that the commissions and courts do not consider the current creditors as forming part of the company. Then, we may ask, why not deduct all liabilities, so as to determine simply the stockholders' investment? The answer is that all interests except current creditors' are treated as the company's and are therefore included in the valuation.

With this clearly extended notion of the corporation there should be a corresponding extension of the idea of capitalization. The broadest view would include all the interests in the property except current liabilities; it would include all permanent or long-term investment, while current liabilities would be treated strictly as obligations of the "company." If we accept this idea, then we face the question how to distinguish between obligations to be included under current liabilities and those considered as capitalization.

One line of distinction that might be urged would be the purpose for which the obligation is incurred. If it is for current account, representing labor charged to operating expenses or interest charged to income account, it might be considered as a mere temporary debt and not as investment of the company.

* It should be noted that fixed capital and working capital, as used in most of the prescribed public utility accounts, do not signify "capital" in the accounting sense, but rather as economists use the term, i. e., assets.—J. B.

But, if it represents a charge to property account or funds provided for construction purposes, it would be viewed as investment and included in capitalization. The difficulty with this separation would be that the origin of a liability, or the direct purpose in creating it, does not finally control, whether the item actually represents a current or a property charge. For example, accounts payable may be due to the purchase of materials and supplies, which may finally be used for both current and construction purposes. Or a liability may be due to direct charges to operating expenses, but the funds derived from revenue which might be used for payment are actually employed for construction; then the liability really represents property and should be treated as capitalization. But later funds may be obtained through long-term loans and may be used to pay the obligations in question and thus really serve current purposes. It is practically impossible to keep track of funds in reference to their source and then to trace them to their destination.

A better division between current liabilities and items included under capitalization would be the length of time for which they are issued. For practical purposes obligations issued for a year or less might be treated as current, while those for over a year might be considered capitalization. The public service commissions law of New York and most of the public utility acts follow this idea. The laws contemplate that no capitalization shall be issued except for the acquisition of new property, and they require the authorization of the commission only for obligations issued for a term of more than one year. Debts incurred for a period of a year or less are thus considered as current liabilities and not investment. The difficulty, however, with this distinction is that in the case of holding company organizations much of the construction of the subsidiaries is financed by the holding company in the form of book advances or demand notes. These would appear as current liabilities while in reality they constitute investment.

For practical purposes the best line of separation between capitalization items and current liabilities is whether the obligations are in form interest bearing or non-interest bearing. If the latter, they may be treated as temporary or actual debt of

the company; and if the former, they may be considered as representing capital investment. This distinction corresponds well with the usual business practice. Loans that are really temporary are usually non-interest bearing in form; only relatively long-term debts usually bear direct interest. Moreover, the grouping corresponds with the idea that underlies most of the commission classification of accounts. All interest accruals, whether on so-called funded or unfunded debt, are included among income deductions, being treated strictly as income appropriations, the same as dividend charges. If, therefore, all interest is considered as representing income, should not the obligations in turn be viewed as capital of the company? If interest bearing obligations are not placed under the capital or proprietary group, then logically the interest accruals should be included among the operating expenses and not among income deductions. Since, however, all interest charges are classed as income, then all interest bearing obligations must be considered as capital and consistently should be grouped under the capitalization of the company.

A modification of the simple but logical rule just outlined would have to be made in the case of holding company advances or obligations to any affiliated company in a group. The advances are usually made on open book account and are non-interest bearing in form, although in reality they constitute capital obligations and should be included in the capitalization of the company. While in theory only construction advances should be included, practically, as already explained, it is impossible finely to separate construction from operating liabilities; so the best procedure would probably be to include all amounts owing to associated companies as capital items. In some cases this might include some unjustifiable amounts, but for the most part would probably show the facts more accurately than any arbitrary separation between construction and strictly current advances. It should be remembered that, if there are considerable amounts owing to associated companies on current account, the funds accumulated for payment have probably been used for construction purposes, or in any event the advances have saved the company from furnishing adequate working capital of its own. It seems, therefore, that there can be no serious objection to includ-

ing under capital obligations not only all interest bearing debts but all advances from associated concerns.

In a broad sense, then, we should consider all permanent investment as capitalization and judge permanence along the line just explained. Capitalization would thus include all interest bearing obligations, all advances from associated companies, all capital stock investments, surplus and all reserves created out of income. Consistent with this view, all discounts on the issue of capital stock or interest bearing indebtedness should be excluded, while the premiums should be included. A distinction should be made between operating reserves and capital reserves. The latter are created out of charges to income, representing reinvested earnings, and should be included in capitalization. Operating reserves, however, result through charges to operating expenses and represent public contributions for the complete maintenance of property or for contingent or undetermined operating liabilities. They are not company investments and therefore do not form a part of the capitalization.*

Another item that should be excluded is an amount equal to the accrued dividend payments, corresponding to interest accrued, which should not be viewed as capital. These amounts represent income to be taken by investors. In the case of interest, the amount is definitely determined, but for accrued dividends an adjustment would have to be made on the basis of past dividend payments.

The broad view of capitalization that has been presented corresponds ideally with the actual permanent investment on which income is received by the investors. With proper accounting throughout, the amount would represent the valuation on which a return should be allowed in a rate case. It would be the direct sacrifice incurred by investors for the benefit of the public service. For the future at least this would be the most desirable basis upon which to fix the return to investors. Unfortunately, however, for present or existing investments, the capitalization shown

* The distinction between capital and operating reserves is exceedingly important and should be emphasized in commission classifications. But the idea is not clearly recognized in any classification that the writer has seen. This simply means that in this respect as in various others, accounting classifications have not been drawn up consistently throughout with the views that are or should be followed in rate cases.—J. B.

by the companies has no special significance. The amounts shown in too many cases represent no actual investment, and in no case could be accepted outright as measuring the direct sacrifice by investors and as the basis of a return in a rate case. For this reason, until the properties of the public service corporations have been especially valued for the purpose of controlling the return on investment, and the amounts have been taken on the books and the capitalization adjusted accordingly, any classification that may be made will have no economic significance. Thus at present any clear-cut definition of capitalization applied to the companies reporting to the commissions will show only nominal amounts which do not show actual investment or amounts whose income will be protected in rate making.

Some time, however, we may hope that a clear policy of regulation may be adopted so that the control of return to investors may be exercised directly through the accounts. Such a policy would require the adoption of a clear-cut method of valuing existing investment and a general valuation of all present properties; the resulting amounts should be taken on the books of the companies and should be taken as the basis of a return. Then for any future investments additional returns should be allowed according to the rate involved in the issue of securities. Thus the return allowed could be automatically fixed and controlled through the accounts, and any excess profits could go to the state in the form of a franchise tax. Investors would know where they stand; the terms on which they would put their capital to the public service would be clear; present confusion attending all public utility investments would be cleared up and we could have real regulation.*

For the present logical classification is really unimportant, but for the sake of the future there should be consistency in our classification with our method of controlling return on investment.

While in a broad sense capitalization is the proprietary interest of a company, the scope of the term as above outlined is too

* For detailed discussion of regulating the return on public utility investments, see articles by the writer, *Electric Railway Journal,* March 11, 1916, and *Political Science Quarterly,* June, 1916. For discussion of the desirable basis for valuing existing properties, see *Political Science Quarterly,* June, 1915, and *Quarterly Journal of Economics,* June, 1916.

broad to be at all consistent with ordinary usage. Although the latter has not been definitely determined, still, when we speak of the capitalization of a company, we scarcely think of premiums, surplus and reserves—which nevertheless constitute capital investment. Not to depart too far from every-day meaning, we might limit the term capitalization to the par amount of what we may call capital obligations, including capital stock, bonds, all interest bearing debts and advances from affiliated companies. Then, in order to show the complete capitalization, we might make a second grouping under the title capital reserve, which would include all premiums less discounts, also the permanent surplus and the reserves created out of income. Capitalization in the broader sense would consist of the sum of the two groups, while in the narrower sense it would be simply the par value of the capital obligations.

The limitation that has been suggested would correspond clearly with the popular idea that capitalization represents par value; and the supplementary grouping would provide for a statement of total investment. From a statistical standpoint, however, it may be better to disregard par value and under capital obligations include net primary investments and under capital reserves place all reinvestment of income. While this classification would disregard par value, which really has no great direct accounting importance, it would still keep the term capitalization reasonably close to ordinary usage and would show facts of real significance. Thus capitalization in the narrower sense would include the par value of stocks and bonds, plus premiums and less discounts, all advances from affiliated companies and all interest bearing obligations. The capital reserves would include only income items, sinking fund reserves, miscellaneous special reserves and permanent surplus. And capitalization in the broader sense would include the sum of the two groups.

The grouping just outlined seems to be the most desirable for permanent accounting and statistical purposes. If there had been proper accounting throughout it would show under the first group the net primary or original investment and under the second the amount of reinvested income. A distinction would thus be maintained between the money or equivalent directly put into the

business by the stockholders and other investors and the profits put back into the business. This distinction obviously has importance in rate cases and the control of return on investment. But, whatever particular sub-grouping may be adopted, the classification should nevertheless provide for showing the total investment entitled to a return from the public, i e., the capitalization in the broader sense. While, as already stated, this would have no particular significance at present, for the future, when regulation will have been more definitely determined and when the companies' accounts have been readjusted so as to represent really the investors' sacrifice and the public's obligations, the general classification here suggested seems fairly important.