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"Financial Aspects of Depreciation"

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: It is indeed disagreeable to play the rôle of confirmed critic. Much worse would it be if that function, instead of being disagreeable, proved pleasurable, for it is a sorry comment on one's disposition to say that malicious pleasure is found in being disagreeable. But whether constrained by the stern daughter of the voice of God, or merely yielding to a cantankerous disposition, I am impelled again to protest against an accountant's discussion of depreciation.

Professor Saliers says in the November JOURNAL OF ACCOUNTANCY that the primary object of the periodic depreciation allowance . . . is not accomplished unless the depreciation is actually earned. The use of "earned" in this place is questionable. How can one earn Professor William Morse Cole's "hole in the doughnut"? One may earn wages, but wages are not earned by the one who makes a charge to wages expense. It is the one who profits by, not he who suffers from, wages that earns them. The objection is made not merely because of the infelicitous choice of a word, but because if depreciation is said to be earned that seems to imply that the allowance for depreciation, as it is too often expressed, "represents profits withheld."

A second criticism perhaps trespasses on the subject so brilliantly handled by Mr. Richardson. It is said that the charge to depreciation expense is "to *provide* for . . . expired outlay on plant." But Professor Saliers has always maintained that depreciation represents the consumption or amortization of service value. It refers to the past, not to the future. It shows what has already happened, not what may happen in the future.

The use of the phrase "to provide for" is not merely an assault on Our Blessed Language. It seems to imply that the expense has not already been incurred, but is something for which provision is to be made; somewhat in the sense that the weekly deposits in a special bank account provide for expenditures to be made at Christmas. Professor Saliers would not support this implication. His words could have been better chosen.

A common error is not merely implied but distinctly stated in the following: "The primary object of the periodic depreciation allowance is to preserve the dollar investment in the business." The *primary* object of any accounting entry is to state what has occurred. The author in his numerous writings is commendably sound in saying that depreciation is to be recorded as an expense, similar to wages. Neither he, nor any less distinguished accountant, ever says that the journal entry wages/cash has as its primary object the preservation of the investment. If recognizing that the incurring of an expense prevents *pro tanto* the exaggeration of profits, and *if* such avoidance is the effective force in preventing "unearned" dividends, the investment is maintained—*provided* it is not otherwise impaired. But surely the wages/cash journal entry has for its purpose, primary and ultimate, the showing that the amount of cash has been lessened and that an expense has been incurred. That ought to be, and is, a sufficient reason for the entry, and the primary purpose of recording depreciation is the same.

The underlying thought is correct but the statement: "The long-term drain on working capital due to failure to make adequate reservation for depreciation is almost certain to lead to insolvency" is disconcerting. Presumably the phrase "to make adequate reservation for depreciation" refers not to the establishment of a depreciation fund with certain ear-marked assets, but to the booking of a reserve for depreciation. Perhaps I am in error in this interpretation. If so, may not my error in part be due to the language used, and only partly to my own obtuseness?

The statement is triply misleading: (1) it is the disbursing of cash, not the failure to write something in the ledger, that weakens the financial position; (2) there is no basis for assuming that a long-term policy of recording depreciation means an accumulating fund of current assets. In all probability the funds will be invested in plant, or used in other ways which will not increase the working capital; (3) in many corporations the avoidance of an exaggerated statement of profits is to a considerable extent secured, without any reservation, or specific recognition of depreciation, by treating recurring replacements as expense. This is a procedure strongly advocated by some public utilities.

A peculiar doctrine is announced in regard to insurance. To illustrate the matter, it is assumed that a building which cost $100,000 has depreciated 40 per cent and that a new building would cost $150,000. The author then argues that as the corporation has $40,000 "depreciation recovered" (*sic*) the building should have been insured for $110,000, thus providing $150,000, the replacement cost. But all that was destroyed was a building valued at 60 per cent of its cost new. If a new building would cost $150,000, at the utmost $90,000 is the insurable amount. The standard fire-insurance form used in New York specifically states that insurance covers the depreciated value. Is it different in Louisiana?

The author's scheme would command, in case the building had depreciated $95,000, that the insurance company should come through with $55,000, instead of $7,500. Truly it would be pleasant to receive enough cash to replace the building at present prices —but that simply isn't insurance.

For many years, at divers times and places, I have criticized current expressions regarding depreciation. But all this has been of no effect, and I am beginning to worry lest I, and not the rest of the regiment, am out of step. Will not Professor Saliers set me right? Is the *primary* purpose of accounts other than to record events? Does recording a past happening provide for a future event? Does a book entry prevent insolvency?

Lest this comment seem too biased, and perhaps ill natured, praise is here ungrudgingly given Professor Saliers for his admirable discussion of the effect of a depression on fixed and current assets, his refutation of the crude idea of the relation of efficiency to depreciation, and his explanation of the interrelation of depreciation and provision for the liquidation of debt. So admirable are these that one is tempted to forego the criticism of minor flaws in the article. But one must resist temptation.

Yours truly,

Henry Rand Hatfield

Berkeley, Calif.

Unamortized Discount and Premium on Bonds Refunded

Editor, The Journal of Accountancy:

Dear Sir: The profession cannot fail to be the gainer from discussions such as that initiated by Mr. Freeman in his letter which appeared in your December issue, and in which he discussed the bulletin on the treatment of premium and discount on bonds refunded, issued by the committee on accounting procedure. As vice chairman of that committee I welcome his letter and the opportunity which it affords me to develop certain points, a discussion of which was omitted from the committee's bulletin for the sake of simplicity and brevity. I shall assume that it is proper to carry forward the discount and redemption premium beyond the date of the refunding, and shall limit my discussion to the question of the term over which they should be spread.

When an issue is refunded in advance of maturity, two accounting questions usually arise: one, how to dispose of the unamortized discount and redemption premium on the old issue; the other, how to treat the direct costs of the new issue. The two questions are separate even though they may sometimes be dealt with as one. The committee's bulletin dealt only with the first question.

The main point made by Mr. Freeman is that in the case of such a refunding the annual cost of borrowing for a longer period will usually be higher than that for a shorter period. When, therefore, a corporation refinances on a reduced-interest basis for a term longer than the unexpired term of the old issue, it receives two benefits: (1) "a benefit which must be expressed in terms of the security enjoyed by the company in having its financing arranged for an extended term of years at a satisfactory money cost"; and (2) "an ascertained saving through the reduction in money cost over the unexpired term of the old issue." So far, I should agree with him, and so, I think, would the committee.[1]

Mr. Freeman goes on to say: "To argue that the ascertained saving alone must absorb the cost to the company of the much greater advantage involved in the refinancing is looking at only one factor in the problem."

Mr. Freeman's position seems to me to be, in substance, that if the cost of retiring the old issue is distributed over the term of that issue, and the direct costs of the new financing over the period of the new issue, the earlier period will be overcharged for the reason above stated, and that spreading both costs over the life of the new issue may be regarded as a rough-and-ready way of remedying this injustice. The committee's view would, I think, be that such rough-and-ready methods are likely to prove unsatisfactory; that the two problems exist separately and should not be combined, and that if Mr. Freeman's point is to be recognized, it should be dealt with as a part of the problem of distributing the cost of the new financing.

Where a given course of action is adopted with the expectation of two benefits, the ordinary accounting treatment is either to determine the distribution of costs on the basis of the predominant purpose and to "let the tail go with the hide," or to make as logical an apportionment of the costs as the facts permit.

The committee in its bulletin assumed the case of a bond issue originally made for twenty-five years on a 5¼ per cent "effective rate" basis, which at the end of a ten-year period is redeemed at 105 (on which basis the effective rate to the old maturity would be 4.54 per cent) by an issue of bonds having twenty-five years to run, with a coupon rate of 3½ per cent, and sold to yield par (net). Let us suppose that if the new bond had been given a term of only fifteen years, it could have been sold at a premium. Everyone will agree that if that course had been pursued, the amount to be spread over the fifteen years would have been the unamortized discount on the old issue and the premium of 5 per cent paid on its redemption, less the premium at which the new bonds would have been sold.

If, then, the issue for twenty-five years is made and an apportionment is to be undertaken between the two purposes or benefits mentioned by Mr. Freeman, the correct procedure would seem to be to distribute over the original life of the old bond the cost that would have had to be amortized had the refinancing been for only that term, leaving the balance of the actual costs—or, in other words, the premium sacrificed—to be spread over the period of the extension. One thing, however, is clear—that the cost of the extension as such has no relation to the amount of the premium or discount on the old bonds redeemed.

If an apportionment is not to be made (and there are, I think, many practical objections to attempting to make one), the vital question is to determine which of the two purposes is predominant and should control the apportionment—which is to be regarded as the hide and which as the tail. Mr. Freeman seems to me to regard the anticipated benefit of the extension of maturity as the hide, and the ascertained saving over the term of the old issue as the tail. Surely, however, when a bond that still has fifteen years to run is refinanced, the predominant motive is the saving to be effected over the life of that issue, and therefore the correct course is to distribute the cost over that period.

However, as the unexpired term grows less, the predominance of this motive becomes less clear, and when maturity is near at hand the refunding for the future becomes the major purpose. This is the position in the illustrative cases used by Mr. Freeman. It is generally recognized that it is frequently impossible or inexpedient to arrange refinancing at the precise date of maturity. Costs incurred as a result of effecting the refinancing slightly in advance of maturity are commonly accepted as part of the costs of the new financing. Duplicate interest is one such item, and a modest amount of unamortized discount and redemption premium may properly be regarded as another.[2]

After reconsidering the question in the light of Mr. Freeman's letter, I still feel that the balance of argument is in favor of limiting the period over which the cost of retiring the

[1] See Appendix B to the bulletin and footnote thereto.

[2] Redemption premiums should and usually do taper off to almost nominal figures as maturity approaches. A company called upon to pay a premium of 5 per cent to effect redemption within a year of maturity, as in one of Mr. Freeman's illustrations, should, perhaps, be regarded as merely paying the price of its past improvidence.

old issue is to be spread to the unexpired life of that issue in any case in which that unexpired life is so long as to make the saving over that period the presumptive and adequate motive for the refinancing. In that case, also, it will be so long that estimates of the probable rate of interest that will prevail at the end of it can be only conjectural.

There seems to me to be a need for different treatment in cases where the old bonds are near maturity at the time of refunding. The argument for such a difference in treatment is strengthened by recognition of the fact that the difference between interest costs for shorter and longer maturities is much greater where one of the periods is very short. Thus, at a time when it would be possible to issue a 25-year bond on a 3½ per cent basis, or a 15-year bond on a 3¼ per cent basis, it might be possible to borrow for a year at less than one per cent.

Mr. Freeman's letter is valuable also, I think, as emphasizing the complexities and the conflicting considerations which arise in the case of even seemingly simple accounting questions. Accounting procedure, like the law, is the result of many forces, including history, tradition, custom, and the public interest, so that it is seldom possible for one to say that a particular procedure is either the only proper procedure, or wholly unacceptable. Nevertheless, I am still of the opinion that the decision of the committee rested on sound grounds and was a wise step towards the desirable goal of restricting the number of acceptable alternatives in the treatment of a given type of transaction in industrial practice.

Yours truly,
George O. May

New York, N. Y.

Treatment of Bond Discount

Editor, The Journal of Accountancy:

Dear Sir: The letter by A. F. Reynolds (page 272, October, 1939), regarding the treatment of bond discount, necessarily provokes some comment. While "authorities" may not advocate the deduction of this amount from the face of the bonds, it is more logical to treat the item in that manner than to call the discount an asset. Does bond discount conform to any definition of an asset which any reader has ever seen, heard, or considered? Its nature seems to be that of a valuation account. If this is granted, then it seems imperative to list the amount as a deduction from the liability.

Also, why do public accountants persist in using the phrase "generally accepted accounting principles"? The application of the varying statutes, proprietorship, industries, and logic tests seems to lead to the jolting conclusion that there are no accounting principles. Thus, it is embarrassing and awkward to attempt to justify propositions, doctrines, conventions, rules, practices, methods, and standards as "principles" of accounting. Perhaps, "when the revolution comes," the use of "standards" (or some other equally satisfactory or better word) will replace "principles," not only in auditors' reports but also in accounting literature.

Yours truly,
L. B. Wilkins

Berkeley, Calif.

This Blessed Language

Editor, The Journal of Accountancy:

Dear Sir: The article in the August Journal, wherein Mr. Richardson made reference to the usefulness of the language of Shakespeare, prompted me to wonder just how the short form of report, currently in use by members of the Institute, would sound were it translated not only into the bard's language but his meter as well. The result:

As at the date whereof we needs must speak
According to th' instructions we have got
From you who have employed us, we report
Your books and records we have well run through,
Your system of internal check we viewed
And learned the multitud'nous pains you take
To keep things straight. Your income and expense
We found recorded in the books, and where
We thought we should, we checked it.
Now we say,
In our opinion, subject to your own,
Your balance sheet we do believe discreet;
And as for income, surplus, and the rest,
Why, on the verities by thee made good,
May they not be our oracles as well?
Consistently from year to year they are
Prepared. They're valid; so we do avouch.

Yours truly,
J. Edwin Hanson

Kansas City, Mo.