Comments of

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"Are Current Depreciation Reserves Adequate?"

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The subject of our discussion may be misinterpreted. Perhaps it was intended by the planners of this session that it should be in order that all sides of the present day debate going on in accounting and financial circles would be brought before this meeting.

A homely comparison was used by William Morse Cole, in 1920, to clarify the concept of a depreciation reserve, which by the way is a term he deplored for he used instead the term, "allowance for depreciation." He explained that "the asset account may be said to measure the diameter of a doughnut, and the allowance account to measure the diameter of the hole; so that the substance of the doughnut is indicated by the difference between the two. An allowance account measures a hole in an asset when for statistical reasons we desire to show both the original whole and the present hole." And Henry Rand Hatfield in 1909, when accounting for depreciation was not fully recognized in practice, opened his argument for its recording by saying that "destruction is the law of nature" and, as an example, "all machinery is on an irresistible march to the junk heap, and its progress, while delayed, cannot be prevented by repairs." Depreciation accounting is the equitable measurement of that march to the junk heap or, in terms of the reserves, the growth of the hole in Cole's doughnut.

For purposes of this discussion, I shall apply these principles in support of sticking to cost as the basis for accounting for depreciation. I assume that it will be conceded that the depreciation reserve does not represent a sum of money and that assets do depreciate regardless of whether their owners are operating at a profit or not. Some evidence of misconception as to these points has reappeared in the last year and a half, but I believe we can consider that these erroneous ideas do not possess enough vigor to cause any trouble. A third point listed by Hatfield in 1927 as to which a misconception sometimes arises is whether the allowance for depreciation is a provision for the replacement of an asset. In various forms this or related questions have been revived to the extent that they are live issues today. Perhaps the root of this revival was expressed in the New Yorker cartoon in which the employee approaching the boss for a raise says, "But with things the way they are today, I have to get twice what I'm worth."

Let me take the subject literally and get down to facts. Are current depreciation reserves in the milk industry adequate? Some facts available for consideration are found in annual reports filed with the Securities and Exchange Commission by eleven corporations in the industry. These reports for 1947 and the fiscal years ended in the early part of this year contain financial statements accompanied, as required by the Commission's rules, by certificates of independent public accountants. All of the certificates recite that the financial statements present fairly the position of the companies and results of operations in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. None of the certificates contains any exception with respect to depreciation policies, charges or reserves. In compliance with the Commission's regulations, the notes to the financial statements set forth the companies' policies with respect to the provision for depreciation and obsolescence of physical properties, including the methods and rates used; the accounting treatment for maintenance, repairs, renewals, and betterments; and the adjustment of the accumulated reserves for depreciation and obsolescence at the time properties are retired or otherwise disposed of.

General statements describing depreciation policies vary somewhat in language but convey the idea that allowances for depreciation are provided by charges to costs or expenses at

rates based upon estimated useful life of the assets. In details of application the methods range from a strict straight-line basis applied to individual items through various treatments of composite rates. Rates are applied to cost except that it must be noted that in nine of the eleven companies an undisclosed portion of the total of depreciable assets is carried at lower than cost as a result of appraisals during the 1930's. In a few cases fully amortized emergency facilities are separately stated and excluded from the depreciation base. The amounts in this category do not appear to be material in relation to total properties in use. However, in the normal course of events assets reach a fully depreciated status on the books, yet remain in active service. It is impossible to determine from the reports the volume in this category, but one of the largest companies disclosed a figure for such assets excluded from the depreciation base which amounted to approximately thirteen per cent of the balance sheet total of property subject to depreciation or twelve per cent of the total if the excluded amount were included.

The eleven companies at the close of the last fiscal year reported a total of $471,000,000 in property, plant and equipment, exclusive of land, with respect to which there were reserves for depreciation totalling $219,000,000 or 46.5 per cent. Depreciation charged to profit and loss during the year totalled $27,000,000 or 6.1 per cent of the average of the opening and closing balances of the related assets. The range in rates reported for particular assets was from a low of 1½ per cent for buildings to a high of 50 per cent for motor vehicles. For the same period, charges for maintenance and repairs for the same companies were reported to be $46,000,000, 70 per cent more than the depreciation charges for the year. Since no exceptions were taken by the certifying accountants, and the financial statements were represented by them and management as fairly presenting the condition of the business and results of operations, I must conclude that both parties deemed the current year's charges and the accumulated reserves for depreciation to be adequate in accordance with generally accepted accounting principles. In one case a footnote quoting the rates used contained the statement, "The above rates used for 1947 are believed to be adequate under peacetime conditions, whereas in 1946, and in the war years, higher rates were used."

The most recent comparable figures I could obtain from the Bureau of Internal Revenue were for 1945. These figures indicate that the eleven companies registered with the S.E.C. constitute a very substantial portion of the dairy industry. Calculated on the same basis as for our eleven companies, the Bureau figures disclose a reserve for depreciation of 51 per cent and an overall composite rate of 5.5 per cent for corporations in the dairy industry. This latter figure is an approximation as the beginning and end of the year statistics are not identical in composition, but I believe the discrepancy is not material. For all corporations filing tax returns for 1945, similar calculations show a reserve for depreciation of 40 per cent and an overall composite rate of 3 per cent.

There should be no doubt that the concept of depreciation on cost is a generally accepted accounting principle. In October 1942, the Committee on Accounting Procedure of the American Institute of Accountants published as its Bulletin No.. 16 a report of the Institute's Committee on Terminology in which definitions of depreciation are examined and tentative definitions formulated for discussion. These set forth the cost concept after a discussion in which one paragraph, significant in the light of present day discussions, reads as follows:

> "It may be desirable to point out that depreciation is only indirectly related to replacement. It contemplates the amortization of the cost of existing property – not anticipation of the cost of replacing it as a replacement reserve might do. Whatever may be the merits of these two approaches to the determination of the proper charges to operations in respect of property which has a limited life and must be replaced if operations are to continue, it must be recognized that they differ. In one case changes in price levels are reflected in the new capital-asset account; in the other, they are reflected in operating charges."

The problem was reexamined by the Accounting Procedure Committee a year ago this September and a public announcement was made of their conclusion that "accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level." After a year of active discussion of the subject, the Committee, with four of the twenty-one members dissenting, reaffirmed its opinion in a notice to members of the Institute on October 14, 1948 by saying that "any basic changes in the accounting treatment of depreciation should await further study of the nature and concept of business income." Taking the position that "the immediate problem can and should be met by financial management," the Committee said that:

> "Stockholders, employees, and the general public should be informed that a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business. The committee therefore gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings."

This reaffirmation of opinion appears to have been influenced by the results of a survey conducted by the Institute this summer. The inquiry which consisted of seven questions opened with the question, "Do you think a substantial change in accounting methods is necessary to provide satisfactory reporting of corporate income in view of recent changes in price levels?" Letters were sent to 410 business executives, bankers, economists, statisticians, labor representatives, accounting teachers, lawyers, government officials, controllers, investment trust officers and security analysts believed to be familiar with the problem of business reporting. A report on October 7th contained an analysis of 225 replies of which 188 expressed opinions. Of these, 96 were unqualified "no's" to the key question and 38 additional replies of "no" and 22 replies of "yes" were qualified by the opinion that the present method of reporting should be retained but should be supplemented by an additional statement to reflect the effect of changing price levels. Thus 156 of the 188 would stay on a cost basis for the primary financial reports, a rather overwhelming endorsement of present generally accepted accounting principles.

The position of advocates of adhering to cost as a basis for depreciation is that depreciation accounting is not intended to provide a replacement reserve. In a business operating consistently at a profit, funds equal to the depreciation charges do become available. The disposition of these funds and the providing of additional amounts, if these are inadequate for current replacement, is believed to be a financial problem of management and not a problem of accounting. The sample of the milk industry represented by registrants with the Commission, as I have said, covers a substantial portion of the investment in the industry. In my review of the

notes to the financial statements for the past year, I found only one direct recognition of the current discussion over depreciation policies. In a note to the profit and loss statement referring to depreciation, the registrant said, "Such depreciation has been accounted on the basis of original cost without recognition of prospective replacement cost indicated by the present increased general price level." In notes describing the carrying value of the property, plant and equipment, this company and three others point out that the amounts shown do not purport to represent present day realizable values or current replacement cost. One of these companies and one other revealed a special earmarking of plant replacement funds: in one case this is described as "unsegregated bank funds" but displayed in the fixed asset section of the balance sheet; in the other, the item is presented on the balance sheet between the sections for "investments" and for "property, plant and equipment." This is described as "Special Fund: United States Government securities to be applied in meeting capital expenditures in excess of normal additions – as authorized by board of directors." There is a schedule reference and a parenthetical notation that "Unfilled orders and commitments approximate the amount of the fund." The fund was used in the succeeding year. Property schedules in this case revealed additions to property, plant and equipment approximately ten percent in excess of the sum of the current year's provision for depreciation, proceeds of sales of fixed assets and the special fund. The amount involved represented a ten percent increase in gross plant.

This last example may be extended to the eleven companies registered with the S.E.C. For the year 1947 cost of additions to property, plant and equipment, exclusive of land, totalled $83,000,000 of which only a minor amount was identified as being in connection with new businesses acquired. Depreciation charges for the year totalled $27,000,000 and proceeds of sales of property, plant and equipment, exclusive of land, appeared to be $10,000,000 or a total of funds available from these sources of $37,000,000, leaving $46,000,000 to come from other sources. Net income for the eleven companies for the same period was $57,000,000 but dividends paid during the year amounted to $30,000,000 leaving $27,000,000 for reinvestment in the business. $19,000,000 therefore came from other sources to balance the plant expansion for the year. As we have seen in one case, funds had been set aside in a special fund for this purpose. How much of the $83,000,000 is replacement and how much represents expansion, my figures fail to reveal. As I have said, only a small amount is identified in the reports as acquisitions of new businesses. In the schedules furnished by one of the smaller companies in the group, a footnote to the additions total (about 20 percent increase in the year) states that these "although extensive, do not indicate any significant or unusual change in the general character or location of the business, but rather a general expansion of present facilities."

That a substantial portion of the amounts reported as additions represent replacements of retired facilities at prices substantially higher than original costs of items of approximately identical service value must be admitted. One of your members has given me some typical examples from his records in which depreciation is calculated on a group composite basis. A light truck bought in 1938 for $1200 and still in service was matched this year for $1900. A tank truck costing $5000 in 1936 and still in service was matched in late 1946 for $6800. In these two examples good maintenance has contributed to longer life than the average expectancy for the groups. I suspect that this is not an uncommon condition in old, well managed companies. These items lend support to the conclusions that may be drawn as to the adequacy of the reserves from the overall figures I have given. A more drastic price increase has occurred in the

replacement cost of holding tanks. Items costing $12,000 in 1929, I am told, cost $27,000 today. This may be fuel for the replacement theorist. But in any event, and regardless of the accounting, multiplication of such figures presents a financial problem of considerable magnitude for corporate management.

The material I have discussed brings me back to the basic question, "Are Current Depreciation Reserves Adequate?" Adequate for what purpose? In the generally accepted accounting sense of measuring the "hole" in the assets, I think I have shown that management and their independent accountants answer "yes" to the original question. If the question was intended to imply that depreciation is a function of replacement, I doubt if anyone here can answer it with confidence, even though at present price levels substantial inadequacy may be indicated. Who knows today when replacement will take place and at what cost in relation to recorded costs of items replaced? If present price levels are employed as a measure, who can say now how a provision for depreciation accumulated at varying rates will compare with ultimate replacement cost? This financial problem is most pressing in industries employing large amounts of long lived assets which must be replaced only at irregular and long intervals of time. The situation is clearly less acute in a business with a minor investment in fixed assets or in short lived assets which must be replaced on a fairly regular program. Although 1947 annual reports to stockholders of three of the largest companies in the milk industry discuss the impact of inflationary forces on commodity prices, costs of doing business and profits, none of them discusses the depreciation problem. The nearest approach is in the report of the largest of these companies in which contemplated expenditures for replacements and additions to property, plant and equipment are mentioned. It was expected in this case that funds needed for the purpose would be provided from cash resources, depreciation, and future earnings. The report states that the extent to which the program would be continued depended upon the economic situation and cash resources as they develop. The other two reports associate profits for the year after dividends, depreciation for the year, and capital expenditures without raising the price index or replacement aspect of the problem. One of the reports is notable for the thorough d forthright manner in which the president defends the company against the popular charge that current profits are inexcusably high or excessive and that insufficient dividends are paid. Part of his answer bears on our subject. He says that earnings in excess of dividends paid have gone into the increase in net current assets or to the increase of capital assets necessary to keep production equal to demand for their product. "Making expenditures from earnings," he says, "to enable us to carry on such operations as will meet the larger demand will, in the course of time inevitably justify itself to the end of still higher annual earnings and a higher rate of dividends." These examples and others that could be cited from stockholders reports from other branches of industry, indicate that adequate supplementary disclosure can be made of the influence of changing price levels on the financial management of corporations without tampering with depreciation accounting on a cost basis in accordance with present day generally accepted principles of accounting.

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