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EXCHANGE COMMISSION  
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Remarks of Maurice C. Kaplan, Attorney,  
Securities and Exchange Commission, be-  
fore the Annual Meeting, Section of Pub-  
lic Utility Law, American Bar Association,  
at Indianapolis, Indiana, September 30,  
1941.

**DEPRECIATION UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935**

The Securities and Exchange Commission has, in a sense, a more limited interest in depreciation than do rate regulatory commissions. Under the Holding Company Act, the Commission has no direct powers or responsibilities with respect to depreciation as a factor in allowable expenses for rate regulatory purposes, nor with the proper function of the accrued depreciation reserve in determining the rate base. That is the problem of the various state commissions and, in some respects, of the Federal Power Commission.

The SEC's statutory concern with depreciation arises out of the obligations which Congress has placed upon it under the various sections of the Act, in regard to holding company-subsidary company relationships, to protect the financial integrity of companies in holding company systems, to safe-guard the working capital of public utility companies, to prevent the payment of dividends out of capital or unearned surplus, and to refuse to permit the issuance of securities which do not conform to certain specific statutory standards, implicit in which is adequate depreciation. In addition, the Commission's powers as to the accounts and records of holding companies and subsidiaries, including depreciation, and its powers as to the simplification and elimination of unnecessary complexities in holding company systems may involve jurisdiction over financial aspects of depreciation practices. The specific statutory tasks imposed by Congress upon the Commission reflect a general statutory interest in the prevention of "milking" of operating companies by holding companies through policies of inadequate depreciation and excessive dividends and, more affirmatively, a statutory interest in the maintenance or establishment of strong and healthy utility companies.

The serious ill effects of inadequate depreciation upon the financial well-being of a utility company and its detrimental effects upon investors and consumers are recognized almost universally today. Depreciation expense is an operating cost which measures the loss in the useful life of the utility plant. If the annual accruals for depreciation are understated, there is a corresponding overstatement of net income and earned surplus. Investors are given an illusory and false impression as to earning coverage. Moreover, if the overstated earnings are paid out in dividends, as they frequently are, the financial integrity of the company is jeopardized and its capital may be impaired. The failure to accrue sufficient amounts for depreciation also results in an inadequate depreciation reserve and, as a consequence, the net book value of the company's assets is exaggerated. This, likewise, is seriously misleading to investors. Obviously, the maintenance of invested capital must precede the showing of profits; hence all costs and expenses of doing business, including the expiration of capital investment through depreciation, must be deducted from gross revenues if management, investors and consumers are to avoid being deceived as to the financial condition of the company.

Few, if any, non-utility American industries have been characterized by policies of inadequate depreciation to the extent practiced in that segment of the electric and gas industries controlled by holding companies.

The existence of such practices in holding company systems is not purely fortuitous. In the late 1920's, when the holding company was selling its securities to the public at roseate price levels, it was considered desirable to have financial statements showing great profits and substantial dividend income from subsidiaries in order to bolster and maintain the market for holding company securities. When the great deflation occurred, the pressure to keep depreciation down and to maintain dividends to the parent company was accentuated. Many holding companies needed the "dividends" badly to service their securities, to keep them, in some cases, from bankruptcy or from the accumulation of preferred stock arrears. The interests of consumers and of direct investors in the operating company--the bond holders and preferred stockholders of the operating company--and the long-run interests of holding company security holders in not receiving a return of their capital under the guise of dividends were neglected in these holding company's efforts to stay afloat.

During these periods, some regulatory commissions did not take active steps to force more adequate depreciation for corporate purposes. Statutes prescribing the powers of many state commissions gave them only limited duties in the preservation of the general financial integrity of operating companies and, while adequate depreciation might be allowed for rate making purposes by a state commission, the utility, for corporate and dividend purposes, might legally follow entirely different practices. There was, undoubtedly, some feeling, too, that there was a conflict of interest between investors and consumers as to adequate depreciation and that a consumer's primary concern was merely to prevent excessive depreciation as an allowable expense in the rate making process. The feeling that a conflict of interest existed between investor and consumers as to depreciation was undoubtedly aided by the contention of utilities that the accrued depreciation reserve should not be deducted from the rate base.

The use of the now discredited retirement method of accounting, which had the sanction of regulatory authorities for many years, was also partially responsible for the inadequate accruals and reserves in the industry. This method tended merely to provide for property retirements that would materialize in the near future and did not purport to take into account the depreciation of other assets which had an expected longer life. The retirement method ignored the necessity of a regular amortization of depreciable assets over their useful life for the proper determination of income. It, furthermore, contains grave inherent dangers when the accounting company is a part of a youthful and growing industry--such as the electric power industry. Retirements are relatively low in the early years of a new industry or when the industry is expanding and adding new properties. In the maturing or declining years, however, experience shows that retirements become heavy. Unless the years of youth and growth in the industry have borne a proportionate share of the accumulating depreciation, charges to expenses in the later years must be correspondingly increased. The static or declining business is usually unable to absorb such increased charges, and the inevitable reorganization and write-down of assets, with its attendant losses to investors and consumers, occurs. The history of steam and street railways are cases in point.

The excellent reports on depreciation of the Depreciation Committees of the National Association of Railroad and Utilities Commissioners have done much to foster the growing understanding that investors and consumers have a unified interest in adequate depreciation accruals.

The Securities and Exchange Commission has not attempted to date any over-all efforts to adjust the depreciation practices of the companies under its jurisdiction to present day financial standards of sound corporate practice and accounting. Most of its efforts to improve depreciation accounting have arisen in connection with specific cases brought before the Commission by an applicant utility desiring to issue and sell securities. Obviously, under the standards of the Act, the Commission could not permit the securities to be issued without making efforts to correct important understatement of expenses--such as depreciation--and understatements of the depreciation reserve.

Depreciation accruals permit the retention of funds in the business which are available for the financing of property additions or replacements, debt retirements or similar purposes, with the consequent effect of lessening the number of securities which might otherwise be outstanding. Studies of utility companies show that companies with adequate depreciation reserves have proportionately less securities outstanding in relation to total utility property than companies with small reserves. The Special Committee on Depreciation of the National Association of Railroad and Utilities Commissioners, in their 1938 and 1939 reports, illustrated the effects of depreciation practices on security structure by a comparison of the practices of the Bell Telephone System with the electric utility industry. The Bell Telephone System has followed depreciation accounting consistently since at least 1913, while the greater part of the utility industry has been under the retirement method until recently. As of December 31, 1939, the depreciation reserves of the Bell Telephone System amounted to 28.4% of total telephone plant, and the depreciation reserves of the electric utility industry amounted to 12.5% of total utility plant. As a result of much lower depreciation accruals, the electric utility industry was forced to issue securities for capital replacements or additions to make up the difference. Thus, the ratio of total securities outstanding to total utility plant, investments, and net current assets in the case of the Bell System was 67.7%, compared with 84.5% for the electric utility industry. While the two industries are not strictly comparable, of course, the figures do indicate that lower depreciation accruals inevitably require the issuance of further securities during a large part of the life of the enterprise. Indeed, inadequate depreciation accruals and reserves--where no offsetting "earned surplus" is present--constitute a subtle way of "watering" stock which may have been originally issued for full consideration. The stockholder is paid back his capital in the form of alleged dividends--the stock, however, remains on the books at its full value even though assets reflecting its equity have been drained from the company.

To protect new and existing security holders against such ill effects of inadequate depreciation, the Commission has insisted on certain protective measures. In bond issue cases, indentures have been required to contain a pledge upon the part of the issuer to provide minimum fixed percentages of gross revenues for annual maintenance and depreciation. These percentages have been increased in security issues which have passed through the Commission in the past year. Usually these percentages have been at a bare minimum level and have had an objectional feature in that they are based on gross revenues rather than upon depreciable property--which most authorities strongly prefer. The Commission has also required indenture provisions restricting the issuance of securities based upon property additions attributable to depreciation accruals.

In one case of a large company, the Commission's staff raised the issue of inadequate depreciation and contended that the security issue was not primarily for the purpose of financing the business of the applicant company but rather was to supply it with cash which otherwise would have been available to the company had it not followed practices of inadequate depreciation, coupled with excessive dividends. Prior to the determination of the issues raised by this case, the company withdrew its application. Subsequently, as a result of round-table conferences between the Commission's staff, the State Commission involved, and the company, the company agreed voluntarily to raise its annual depreciation accruals by over a million dollars a year and to "freeze" a reported earned surplus of \$10,000,000 against any future dividend payments.

In the case of inadequate depreciation reserves coming before the Commission in connection with security issues, the Commission has attempted to make up for the mistakes of the past in a number of ways. In certain cases, the reported and fictitious earned surplus has been made unavailable for any dividend charges or for any other charges, except certain limited and specified ones. In other cases, the Commission has required a direct transfer of earned surplus to the depreciation reserve. In the recent Georgia Power Company financing, the company, after round-table conferences with the Commission, agreed to increase its depreciation reserve by an amount in excess of \$13,000,000. In the recent Appalachian Electric Power Company financing, the company consented to a condition in the Commission's Order of Approval setting up a reserve account of \$22,500,000 to be available for possible adjustments to its fixed capital accounts and/or its depreciation reserve accounts. These cases indicate the manner in which the Commission is attempting to bridge the transition from retirement accounting to depreciation accounting.

The impact of the national defense program upon public utilities with their urgent need for ever-increasing amounts of power has made all regulatory commissions unusually sensitive to the importance of adequate depreciation in the financing of property additions. Regulatory authorities would be grossly negligent if they permitted necessary plant expansion to be choked off because the utility had no funds as a result of too low depreciation accruals coupled with too liberal dividend payments, or if securities were permitted to be floated to obtain cash when adequate depreciation would have obviated the necessity for the sale. Like other commissions who are trying to do their job, the SEC is currently studying depreciation and dividend practices of utility companies in defense production areas, particularly where estimates for projected power loads indicate that substantial plant expansion is immediately necessary in the national interest. In appropriate cases, where the interests of the operating company are being slighted in favor of the holding company's continuing to draw up excessive dividends, protective measures should be forthcoming.

There is little question that depreciation practices of the industry have improved substantially in the past few years. The awakened interest of state commissions in adequate depreciation, partially a result of the emphasis upon its necessity by the National Association of Railroad and Public Utilities Commissioners, pressures from the SEC, as well as voluntary action by the industry, have caused a general rise in the level of annual accruals. There is considerable doubt, however, as to whether progress has been sufficient. There remains

a still un-explainable wide gap between depreciation for corporate purposes and depreciation for income tax purposes--a gap which, to some extent, may have some justification, but whose breadth suggests that either the Bureau of Internal Revenue is being fooled badly or that utility companies are still under-accruing. This gap, parenthetically, occurs with much less frequency in the case of industrial companies. Generally speaking, most of the industry still faces the problem of adjusting its accrued depreciation reserves to depreciation accounting standards rather than the discarded retirement system. These are some of the depreciation problems facing the industry and regulatory commissions in the coming years.