

RELEASE NO. 53

November 16, 1945

SECURITIES ACT OF 1933
Release No. 3100

SECURITIES EXCHANGE ACT OF 1934
Release No. 3750

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 6200

In the Matter of "Charges in Lieu of Taxes"—Statement of the Commission's Opinion Regarding "Charges in Lieu of Income Taxes" and "Provisions for Income Taxes" in the Profit and Loss Statement.

The purpose of this statement is to outline the Commission's views in the matter of so-called "Charges in lieu of income taxes" and of "Provisions for income taxes" which are intentionally in excess of those actually expected to be payable; to give the reasons for that opinion; and to state its views on the points which certain accounting firms have made in connection with the principles discussed herein.

For some time there has been growing up a practice, tolerated by some accountants and sincerely advocated by others, pursuant to which the current income account is charged under the heading of income taxes or charges in lieu of income taxes, not only with the income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year.¹ Certain public utility companies have included such charges and excessive income tax provisions among their operating expenses. This additional charge against income is, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The amount of the estimated reduction has been colloquially termed a "tax

¹ In general, the unusual circumstances are based on differences in the accounting treatment of certain items for income tax purposes and for general financial purposes. For example, losses and expenses which had to be taken as income tax deductions in a given period were not also taken as deductions in the profit and loss statement for the same period. Instead, because of differences in accounting methods, such items had already been charged off against income in previous years, or were being charged off directly to surplus or reserves, or were to be deferred and charged off against income in future years.

saving" and the general problem is loosely referred to as the "treatment of tax savings."²

This practice with its variants has caused the Commission some concern and it seems desirable now to state our views as to the accounting procedures appropriate in such situations and to give the reasons for them. In summary, our conclusions are as follows:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws.
2. It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes.³
3. The use of the caption "Charges or provisions in lieu of taxes" is not acceptable.
4. If it is determined, in view of the tax effect now attributable to certain transactions,

² We think this terminology is undesirable in principle and possibly misleading. Our preference is to call them "tax reductions." See note 23 *infra*.

³ Under the controlling decisions of the Federal courts (*Helvering v. California Oregon Power Co.*, 75 F. (2d) 644 (1935) D. of C., *Helvering v. Union Public Service Co.*, 75 F. (2d) 723 (1935) Eighth Circuit) unamortized bond discount and expense applicable to bonds being refunded through the issuance of new bonds for cash are deductible for purposes of the Federal income tax in the year in which the refunding takes place. Not all accountants, however, are in accord that such items must as a matter of sound accounting be immediately written off. Many believe that such items should preferably be amortized against income over the life of the refunding issue if a correct statement of the cost of money is to be obtained. (Cf. Healy, *Treatment of Debt, Discount and Premium Upon Refunding*, 73 *Journal of Accountancy*, 199 (March 1942).)

to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses written off.

5. The location within the income statement of any such special charge should depend on the nature of the item being written off. In the case of a public utility, for example, a special amortization of bond discount and expense should not be shown as an operating expense but should be classified as a special item along with other interest and debt service charges in the "other deductions" section.

6. It is appropriate to call attention to the existence of the special charge by the use of appropriate explanatory language in connection with intermediate balances and totals.

7. In the preparation of statements reflecting estimates of future earnings, it is ordinarily permissible to reflect as income taxes the amount which it is expected will be payable if such earnings are realized provided, of course, the assumptions as to the tax rates are disclosed.

8. In the preparation of statements which are designed to "give effect" to specified transactions, the provision for taxes may, depending on all the facts and circumstances, properly represent either (a) the actual taxes paid during the period adjusted to give effect to the specified transactions, or, (b) an estimate of the taxes that it is expected will be payable should the income of future years be equal in amount to the adjusted income shown in the statement. The statement should, of course, clearly show what the provision for taxes purports to represent.

The reasons for our views can best be developed by using the facts relating to a registration statement recently filed by the Virginia Electric and Power Company (VEPCO) under the Securities Act of 1933 in which we took a position in the matter. This case is chosen not only because its facts are typical of most cases in which this problem arises but also because the public accountants who certified the financial statements in that case have since appeared before us and pre-

sented in detail their views in the matter.⁴ The discussion of this case and of the general problem which it typifies will be presented under the following main headings:

I. *The background of the Vepco Case*—A brief description of the registration and of the transactions giving rise to the problem.

II. *The Certified Financial Statements Originally Filed*—A description of the certified financial statements originally filed, pointing out briefly our difficulties with the way in which the so-called "tax saving" was handled.

III. *Amendments to the Certified Statements*—A description of the certified income statements after each of the amendments, pointing out briefly in each case our objections to the treatment accorded tax provisions and "tax savings."

IV. *The Pro Forma Income Statements*—A brief description of the *pro forma* statements filed, pointing out our objections to the treatment of taxes in the statements originally filed.

V. *The Findings and Opinion of the Commission in the Related Case—In the Matter of Virginia Electric and Power Company (H. C. A. Release 5741)*—A description of the financial statements and ratios set forth in that opinion which were criticized in some respects by the

⁴ In the summer of 1944, we caused to be circulated for comment a proposed Accounting Series release containing a tentative statement of our conclusions in this matter. Comments were received from accountants, registrants and others interested in the problem and a number of informal conferences were arranged with the staff and the Commission. Of the 28 letters and comments received, 5 individuals or firms and a committee of the American Institute of Accountants objected to the general position taken in the draft. Subsequently, in December, 1944, the Committee on Accounting Procedure of the American Institute of Accountants issued a bulletin "Accounting for Income Taxes" which in a number of important respects is inconsistent with the conclusions we have reached. In January, 1945, the Committee on Accounting Principles and Practice of the New Jersey Society of Certified Public Accountants issued a statement with respect to the A.I.A. bulletin, taking some exception to the proposals made as to the treatment of "tax savings." In coming to a final conclusion in this matter, we have given extensive consideration to the views expressed and the points made by those commenting on the tentative statement of our views, as well as to the contrary position taken in the bulletin mentioned.

certifying accountants in their discussion of this problem.

VI. *The treatment of "Tax Savings" in Financial Statements Filed with this Commission*—A detailed discussion of the considerations underlying our views as to the treatment of income taxes and of so-called "tax savings."

1

THE BACKGROUND OF THE VEPCO CASE

On March 23, 1945, the Virginia Electric and Power Company (VEPCO) filed with this Commission under the Securities Act of 1933 a registration statement covering its First and Refunding Mortgage Bonds, Series E. The statement after being amended several times became effective on April 20, 1945, as to \$59 million of such bonds. Certain financial statements of VEPCO included in the registration statement were certified by Lybrand, Ross Brothers & Montgomery. Those of Virginia Public Service Company, a company recently merged with VEPCO, were certified by Arthur Andersen & Co. Several days after the amended statement became effective, representatives of both firms of certifying accountants appeared before the Commission to discuss certain accounting questions as to the treatment of income taxes and of the so-called "tax savings."

In the registration statement filed by VEPCO, certified financial statements for the years 1942, 1943 and 1944 were filed for VEPCO, for Virginia Public Service Company which had been merged with VEPCO on May 26, 1944, and for the two companies combined. In addition, there were filed "adjusted" balance sheets and income statements designed to give effect to the merger with Virginia Public Service Company, the sale of certain transportation properties, the proposed refinancing and certain related adjustments.

The accounting and "tax savings" issues centered on the treatment to be accorded the following three items which arose out of transactions that had occurred in 1944.

1. Premiums and expenses incurred in refunding VEPCO's bonds, amounting to \$2,388,096.46.⁵

⁵ In 1942 Virginia Public Service Company called for redemption certain of its outstanding bonds. Unamortized

2. A loss of \$3,418,715.16 sustained upon the sale by VEPCO of certain transportation properties.

3. An item of \$600,949 said to arise out of the asserted fact that the normal depreciation of certain plant facilities was substantially less than the amortization of such facilities taken for tax purposes at 20 percent per annum under Section 124 of the Internal Revenue Code.⁶

In the original registration statement, and in all of the amendments, the registrant and its accountants took the position that the income statements should be prepared in such a way as to reflect therein charges equal to what it was estimated Federal excess profits taxes would have been had not the special transactions occurred. In the original filing the provision for excess profits taxes was shown as an operating expense not in the amount expected to be paid but in the amount that would have been payable had not the three special items existed. After the second amendment, the provision for excess profits taxes was shown at what was actually estimated to be payable for the current year under the applicable tax law, but a separate additional charge, specially described, was also included among the operating expenses in an amount equal to the difference between the provision for actual taxes and the estimated provision that would have been needed had not

debt discount and expense, call premium and expenses applicable to the redeemed bonds amounted to \$2,021,708.13. Solely in order to simplify the present discussion, this item is not discussed in detail although its treatment involved much the same problems as the 1944 refunding.

⁶ Section 124 of the Internal Revenue Code provides for the deduction by taxpayers, at their election, of accelerated amortization of property (including land) constituting an "emergency facility" by reason of certification by designated Government authorities that the property was necessary in the interest of national defense. Such amortization, which is in lieu of a deduction for ordinary depreciation usually at a much lower annual rate, is based on an arbitrary 5-year life period but this may be amended to such shorter period as will end with the date officially declared as the end of the emergency war period. The President, by proclamation terminated the emergency period referred to in § 124 as of September 29, 1945. The VEPCO statements do not indicate the dollar amounts of such facilities, the normal depreciation taken, or the amortization taken for tax purposes. The figure of \$609,949 represents the company's estimate of the amount by which Federal taxes would have been increased had only the normal depreciation been taken for tax purposes.

the three items existed. The third and fourth amendments altered the description of these special charges, and their position in the income account. The wording of some of the other related captions was also modified. As finally amended, special charges representing portions of the premium and expenses on redemption of the bonds and of loss on sale of properties were wholly excluded from the operating expenses and set out as a separate item of "deductions from income." The adjustment within the income account based on the treatment of emergency facilities was eliminated. The extent to which this presentation reflects the views expressed in this opinion will be pointed out later.

In Exhibits A, B, C and D there are presented the relevant portions of the 1944 income statement as originally filed and after each amendment.

II

THE CERTIFIED FINANCIAL STATEMENTS ORIGINALLY FILED

The Commission's directly applicable accounting requirements are found in Rules 3-01(a), 3-06, 5-03 and 11-02 of Regulation S-X. The pertinent portions of the rules are reprinted in the footnote:⁷

⁷ a. Rule 5-03 (Profit and Loss or Income Statements) Caption 15—"Provision for income and excess profits taxes.—State separately (a) Federal normal income and excess profits taxes; (b) other Federal income taxes; and (c) other income taxes."

b. Rule 5-03. Caption 12—"Miscellaneous income deductions—State separately, with explanations, any significant amounts, designating clearly the nature of the transactions out of which the items arose."

c. Rule 11-02 (Statement of Surplus) Captions 3 and 4—"3. Other additions to surplus—Specify. If two or more of the classes of surplus specified in the rule as to the form and content of the particular balance sheet are stated in one amount, the nature of other additions to surplus (caption 3) and of other deductions from surplus (caption 4) shall nevertheless be so designated as to indicate clearly their classification in accordance with such applicable rule. 4. Deductions from surplus other than dividends.—Specify. See caption 3."

d. The second sentence of caption 2B of Rule 5-03: "A public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, may follow the general segregation of operating expenses prescribed by such system or report."

e. Rule 3-01 (a)—"Financial statements may be filed in such form and order, and may use such generally accepted

terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

It is apparent that these rules called for the careful segregation and clear description of any nonrecurring or unusual items charged or credited to the income account or to earned surplus. The plain import of caption 15 of Rule 5-03 is that there shall be shown thereunder only amounts actually provided for income taxes.

With those requirements in mind we turn to the income statement originally filed by the registrant, and certified by its accountants, purportedly in conformity to the requirements of the Securities Act and the rules and regulations issued thereunder.

As will be seen from Exhibit A, there was set forth in the 1944 income statement, as an operating expense, an amount for excess profits taxes equal to what the registrant computed would have been the amount of such taxes had none of the three special items existed. This excess profits tax figure appeared under the caption, "Taxes, excluding reductions shown separately below or applied against items charged directly to surplus."

The reduction in taxes attributed by the registrant to the excess of the tax amortization of emergency facilities over the normal depreciation thereon was added back to net income at the very bottom of the statement under this caption:

"Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed through their normal life and not to replace existing facilities \$609,949."

The sum of this item and of a figure labelled "Net Income" was described as "Balance transferred to earned surplus . . ."

In the related surplus statements, charges were set forth in respect of the refunding costs and the

terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

f. Rule 3-06—"The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies."

loss on sale of transportation properties as follows:

"Loss arising in connection with sale in 1944 of transportation property, less resulting reduction in Federal taxes on income...\$1,361,842.16"
 "Redemption premiums and expenses in connection with refunding of bonds, less resulting reduction in Federal taxes on income.....
 -----\$291,919.46"

There were no notes to the certified income or surplus statements in further explanation of these items.⁸

The 1944 income statement as originally filed by

⁸ In the 1942 income statements of Virginia Public Service Company a similar transaction was explained by means of a footnote which if read in conjunction with the surplus statement disclosed the total refunding expenses. The note read as follows:

"(C) Federal Income and Excess Profits Taxes:

"Virginia Public Service Company and subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting amortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these non-recurring deductions in computing the amount of 1942 taxes payable amounts to \$1,517,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as special amortization of debt discount and expense. The balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942 was charged against earned surplus.

"However, the taxable net income as computed did not reflect the deduction, for tax purposes, of losses upon sales of ice and railway property, and certain other items charged to surplus. As a result, provisions charged to income in 1942 were approximately \$330,000 in excess of the company's liability for Federal income taxes as shown in its tax return for that year. Pending review of the returns, this excess provision is included in accrued Federal income and excess profits taxes at December 31, 1943.

"In 1943 the company filed a claim for refund of 1941 Federal taxes in the net amount of approximately \$297,000 under the carry-back provisions of the 1942 Revenue Act. However, this amount is subject to such adjustments as may result from review by the U.S. Treasury Department and the claim has not been recorded upon the books of the company."
 * * * (See also Exhibit A.)

The total refunding expenses can be computed by adding the disclosed reduction of \$1,571,158 to the \$450,549.98 which is shown as a net direct debit to earned surplus.

the registrant and certified by its public accountants, did not comply with the applicable requirements and in our opinion was clearly misleading in the following important respects:

1. The total loss on sale of transportation properties was not shown.
2. The amount of refunding expenses in 1944 could not be determined.
3. The amount provided for the estimated tax liability for 1944 could not be determined.
4. The treatment and disclosure of similar transactions was different. In 1942 the amount of the estimated reduction in taxes due to the refunding was stated; this was not done as to the 1944 refunding. Also the treatment accorded tax deductible losses charged to surplus was different in 1942 than in 1944.

An investor could thus determine from the certified financial statements only that the *sum* of the tax liability *plus* loss on transportation properties *plus* the refunding expenses amounted to a certain figure as follows:

| | |
|---|-----------------|
| Provision for taxes (as shown in the income statement) | |
| Federal income tax..... | \$2,139,496.39 |
| Federal excess profits..... | 8,164,807.79 |
| Post-war credit..... | (351,081.99) |
| Total tax provision..... | 9,953,285.19 |
| Surplus charges, less resulting reduction in Federal taxes on income | |
| Loss on transportation properties..... | 1,361,842.16 |
| Refunding expenses..... | 291,919.46 |
| | 11,607,046.81 |
| Less: | |
| Reduction due to amortization of emergency facilities (as shown in the income statement)..... | 609,949.00 |
| Balance..... | \$10,997,097.81 |

It is true that by reference to the uncertified *pro forma* or adjusted income statements it can be determined that the reduction in taxes due to the items charged to surplus was \$4,148,050. It is obviously unsound, however, to expect that a collateral disclosure in one set of statements will be inevitably and clearly connected by the reader with the information given in another and certified set of statements, at least without a clear cut cross

reference.⁹ This was apparently recognized since in the first amendment a paragraph was added to Note C to the income statement disclosing the \$4,148,050 figure.¹⁰ However, even with this figure before him the reader could determine only the aggregate reduction attributed to two wholly disparate items. It seems self-evident that the actual total loss on transportation properties sold and the total amount of refunding expenses are material facts. We think it equally apparent that the estimated amount of actual taxes is an important fact.¹¹

There is another, though less patent difficulty. The amount shown for excess profits taxes was \$8,164,870.79. The post-war credit against excess profits taxes was shown as \$351,081.99, or at the rate of about 4.3 percent. Since the post-war credit is normally 10 percent of the excess profits tax, the disparate relationship of these two figures should raise a question to even the average reader of the statement. There was, however, no explanation directed to this point. When the figure shown for excess profits taxes was reduced to the actual amount believed to be payable (\$3,406,871.79) no change was made in the amount shown for the

⁹ As we said in our opinion in the matter of *Universal Camera Corporation* (Securities Act Release 3076, June 29, 1945): "A disclosure which makes the facts available in such form that their significance is apparent only upon searching analysis by experts does not meet the standards imposed by the Securities Act of 1933 as we understand that Act."

¹⁰ The first amendment was filed before the staff issued its letter of deficiencies.

¹¹ The treatment in this case is particularly unsatisfactory since the aggregate "reduction" is not divided proportionately between the two items. From the amended statements, it appears that the total loss on transportation properties was \$3,418,715.16 of which \$1,361,842.16 or about 40 percent appeared as a charge to surplus. In the case of the refunding expenses the total amount was \$2,383,096.46 of which, however, only \$291,919.46 or about 12 percent was charged to surplus. Inquiry developed that these differences were due first to the fact that in computing the estimated actual tax for the year, the amount recognized as an allowable tax deduction was about \$1 million less than the \$3,418,715 recorded as a loss on the books; and, second, to the fact that the refunding expenses used as a tax deduction amounted to about \$63,000 more than those written off in the accounts. The amount of the reduction in taxes due to each of these two items was computed by applying a rate of 85.5 percent, that is, the 95 percent excess profits tax rate less the 10 percent post-war credit. Without knowledge of these important facts, even an expert could do no more than guess at what had been done with the accounts.

post-war credit. Apparently the amount by which the excess profits tax provision was increased on account of the charges to surplus was net of the statutory 10 percent credit. In other words, the figure shown as a provision for excess profits taxes was doubly a hybrid. First it combined actual taxes with "tax savings." Second to the extent of the estimated actual liability it was computed at the rate of 95 percent, but as to amounts in excess of actual liability, the rate used appears to have been 85.5 percent—that is, the full 95 percent less the 10 percent post-war credit.

There remains a final point—the caption under which the tax provision was set forth. The language "Taxes—excluding reductions shown separately below or applied against items charged directly to surplus" in our opinion scarcely lends itself to ready understanding but instead is apt very easily to convey exactly the opposite of its intended meaning through its use of "exclude me in" language. In our opinion such a description of this hybrid item represents a distinct barrier rather than an aid to understanding.¹²

In addition to all of the above difficulties, two much more basic questions are presented by the registrant's accounts: (1) whether there may or should be included in the operating expenses of a regulated public utility, under the caption of taxes, any amount in excess of the amount estimated to be actually payable under the applicable provisions of the tax laws; and (2) whether any amount should be included in or with such operating expenses to compensate for the reduction in taxes due to items like those in question here. These issues are raised more clearly by the statements in their amended form and discussion of them will be deferred until the amendments have been described.

III

AMENDMENTS TO THE CERTIFIED FINANCIAL STATEMENTS

In view of objections on the part of the Commission's staff to the income statements as originally filed, a formal letter of deficiencies was sent on April 14, 1945 specifically criticising the presentation of the items under discussion as follows:

¹² See n. 9 *supra*.

Financial Statements
Income Statements

"It is noted that the earned surplus statement for the year 1942 reflects charges aggregating \$497,288.10 representing 'Unamortized debt discount and expense, call premiums and duplicate interest on long-term debt called for redemption, less resulting reduction in Federal taxes on income.' It is also noted that the earned surplus statement for the year 1944 reflects charges of \$1,361,842.16 and \$291,919.46 representing 'Loss arising in connection with sale in 1944 of transportation property' and 'Redemption premium and expenses in connection with refunding of bonds' respectively, less, in each instance, 'resulting reduction in Federal taxes on income.' Further, it is noted that the 1944 income statements reflect 'tax savings' aggregating \$609,949.00 resulting from special amortization of emergency facilities.

"It appears that the total effective charges to savings in Federal income and excess profits taxes resulting from the above redemption of bonds, sale of property and special amortization of emergency facilities should be reflected separately in the income account under an appropriate descriptive title. In this connection, the title 'charge in lieu of taxes' will not meet such requirement. Such amounts should be shown immediately below the total of 'Operating Expenses and Taxes.'"¹³

Following the filing of the first amendment on April 2, there occurred several discussions with the staff based generally on the position taken in the letter of deficiencies dated April 14. In these discussions it was made clear that the staff took the position that the tax provision should not exceed the estimated amount believed to be payable and that charges to the income account "in lieu of taxes" could not be considered operating expenses. The staff also took the position that it

¹³ We do not construe this paragraph to mean that charges may be made to income for the so-called "tax savings," provided only they are separately set forth. If it does, we disagree. We construe the language to mean rather that where taxes are reduced due to special circumstances special charges of an equivalent amount may be made to the income account, if the particular item involved is one that may properly be made to income and if the special charge is clearly described for what it is, for example, "Special charge-off to unamortized bond discount."

would not object to charging the income account with so much of the two items charged to surplus (loss on sale of transportation properties and refunding expenses) as was equal to the company's estimate of the reduction in taxes caused by such items.

The second amendment was filed on April 16, 1945, substantially revising the certified income statement for 1944. In the amended statement, the provision for excess profits taxes was shown at the amount estimated to be actually payable. The following new item, equal to the reduction in the amount shown as excess profits taxes, was inserted under the general heading "Operating Expenses and Taxes."

"Special charges equivalent to reduction in Federal excess profits taxes resulting from special amortization of emergency facilities (reduction shown separately below) and from redemption of bonds and sale of property (reductions applied against related items charges to surplus) ----- \$4,757,999."

The item was inserted immediately after a total captioned "Total Operating expenses and taxes before special charges." The sum of the special charges and the above caption was labeled: "Total operating expenses and taxes including special charges" and this item was then deducted from the total of operating revenues to arrive at a figure labeled: "Net operating revenues." The remainder of the income statement, and the surplus accounts were the same as in the original filing except that a paragraph added by amendment #1 to Note C to the income statement was dropped, presumably because the \$4,148,050 figure it disclosed could now be derived from data given in the income statement.¹⁴ It will be recalled that this figure was the total amount by which taxes were estimated to have been reduced because of the loss on transportation properties and the refunding expenses.

The changes made are summarized in the following table:

| | |
|--|------------------|
| Special charges ----- | \$4,757,999 |
| Reduction due to amortization of emergency facilities (shown as last item of income statement) ----- | 609,949 |
| Remainder applicable to the two surplus items. ----- | <u>4,148,050</u> |

¹⁴ See Exhibit B. The \$4,148,050 figure can be derived as follows:

| | <i>As originally filed</i> | <i>After 2d Amendment :</i> |
|---|--------------------------------|---------------------------------|
| Operating revenues..... | \$51,681,778 | \$51,681,778 |
| Operating expenses and taxes: | | |
| Other than taxes..... | 28,237,367 | 28,237,367 |
| Taxes, excluding reductions shown separately below or applied against items charged directly to surplus ¹⁶ | | |
| Taxes: | | |
| Federal income..... | 2,139,496 | 2,139,496 |
| Federal excess profits..... | 8,164,872 | 3,406,871 |
| Post-war credit..... | (351,082) | (351,082) |
| Other..... | 4,131,408 | 4,131,408 |
| Total..... | <u>42,322,060</u> | <u> </u> |
| Total operating expenses and taxes before special charges..... | <u> </u> | <u>37,564,061</u> |
| Special charges, etc..... | <u> </u> | <u>4,757,999</u> |
| Total operating expenses and taxes, including special charge..... | <u> </u> | <u>42,322,060</u> |
| Net operating revenues..... | <u>9,359,718</u> | <u>9,359,718</u> |

The amended presentation was further questioned by the staff on these points:

1. The continued failure to disclose either the total loss on sale of transportation properties or the total refunding expense.
2. The impropriety of adding the special charges to operating expenses.
3. The propriety of the adjustment within the income account in respect of the amortization of emergency facilities.

The second of these points to some extent may conflict with the last sentence of the deficiency letter, quoted earlier, which read:

“Such amounts (*i.e.*, special charges) should be shown immediately below the total of ‘Operating Expenses and Taxes.’”

Physically, of course, registrant’s amended statement conforms to the deficiency letter by placing the special charges immediately after the total mentioned. It was the staff’s position, however, that the deficiency called for their inclusion at that point as a separate, distinct and different item, rather than in such a way as to imply that the special charges were true operating expenses, though perhaps nonrecurring in nature. We feel that the language of the deficiency letter might well

¹⁶ This caption was deleted by the second amendment and the caption “Taxes” substituted therefor.

have been more explicit and so more in conformity with the oral statements made by staff members. In any event, however, the point is now moot since when the case was presented to us for directions, it was determined not to permit inclusion of such charges in or with operating expenses.

After some further discussion of the matter with the registrant and its accountants, the staff brought the case to the Commission for directions, presenting for consideration the history of the case and the views of the registrant and its accountants both in this and other similar cases. We thereupon directed the staff to advise the registrant to the following effect:

1. That no adjustment should be made within the income statement based on the estimated reduction of income taxes due to the amortization of emergency facilities.¹⁶
2. That no objection would be raised to the inclusion in the income statement of an item of \$4,148,050 representing so much of the refunding expenses¹⁷ and of the loss on disposition of property as was equal to the estimated reduction in income taxes attributable thereto, the re-

¹⁶ Our views as to this particular variant of the general problem are outlined in n. 35, *infra*.

¹⁷ According to the registration statement these costs consisted of redemption premiums and expenses in connection with the refunding of the bonds.

mainder of both these items being charged directly to surplus: *Provided, however*, (a) That the caption for the item indicate clearly the nature and amount of the item being charged off and (b) that the special charge be excluded from operating expenses and shown as a deduction from gross income.

After being advised as to our views, the registrant on April 19, 1945, filed a third amendment. In the revised income statement, the \$609,949 adjustment based on the amortization of emergency facilities was omitted and taxes were shown at the actual estimated amount thereof. The \$4,148,050 of Special Charges was set forth as a separate item in the following manner:

| | |
|--|---------------------|
| Gross income (before special charges below)..... | \$14,072,358.24 |
| Special charges equivalent to reduction in Federal excess profits taxes resulting from redemption of bonds (\$2,091,177) and sale of property (\$2,056,873) (reductions applied against related items charged to surplus)..... | 4,148,050.00 |
| Gross income (after special charges)..... | 9,924,308.24 |
| Deductions from income..... | 3,719,526.80 |
| Net income..... | <u>6,204,781.44</u> |

The qualification "before special charges below" was also added to two prior captions so that they read as follows:

"Total operating expenses and taxes (before special charges below)."

"Net operating revenues (before special charges below)."

In addition Note C to the tax item was amended to disclose that no adjustment had been made in the income statement on account of the difference between depreciation taken therein on emergency facilities and the amount claimed therefor as amortization under Section 124 of the Revenue Code. The amount by which taxes were affected through this difference was given.

The staff brought the revised statements to our attention and we indicated that in our view the special charges should be classified as "other deductions" inasmuch as they represented items which, if charged to income, should, under the classifications of accounts to which the registrant

was subject, be charged as an item of other deductions.

Upon being advised of these views the registrant filed its fourth amendment on April 20 in which the special charges were classified as an item of other deductions and Note C was expanded somewhat to set forth specifically the amounts charged to income in respect of the refunding expenses and the loss on transportation properties. As revised, the note no longer stated the amount of the tax reduction attributed by the registrant to the difference between the amount of depreciation and amortization taken on the emergency facilities. However, this amount can be derived from the other figures shown.

In transmitting to the registrant our views on the income statement as set forth in the third amendment, the staff indicated that the use of the words "before special charges below" in the several captions mentioned above was objectionable. We do not believe this position to be wholly sound. We feel that the existence of large special and unusual transactions ought properly to be forcefully brought to the attention of the reader of the statement. We feel also that the use of appropriate qualifying words such as "see special charges" in connection with the pertinent captions is an appropriate means of warning the reader of the existence of such items as were present in this case.

IV

THE PRO FORMA INCOME STATEMENTS

In addition to the certified income statements for the years 1942-44, the registrant filed uncertified *pro forma* income statements under the following general title:

"Virginia Electric and Power Company
Pro Forma Income Statement for 12 months
 ended December 31, 1944,
 Giving estimated effect as at January 1, 1944 to
 Merger,
 Sale of Transportation Properties and Proposed
 Refinancing."

The actual 1944 income statements of VEPCO, and of Virginia Public Service prior to its merger with VEPCO on May 26, 1944, were shown in two separate columns. In five additional columns there were shown (1) adjustments to give effect to the

merger, (2) adjustments reflecting the sale of transportation properties, (3) adjusted statements prior to the proposed refinancing, (4) the refinancing adjustments, and (5) adjusted statements after the refinancing. We are here concerned primarily with the treatment accorded the tax items although some reference to other adjustments may be necessary.

In general, the presentation followed quite closely that used in the certified statements. As originally filed the total of income tax items shown in the two "actual" columns was the same as that shown in the certified statements, \$9,953,285. This figure and the adjusted figure were both described as "Taxes—Federal income and excess profits (excluding reductions (1) as shown separately below and (2) of \$4,148,050 related to and applied against items charged directly to surplus)." As pointed out earlier, these uncertified statements disclosed that which the original certified statements did not—the aggregate tax reduction resulting from the two items charged to surplus. In the statements filed adjustments of the "actual" tax figure were as follows:¹⁸

| | |
|--|-------------------|
| Tax provision as shown in the certified statements..... | \$9,953,285 |
| Add: | |
| Increase due to 1944 merger and refinancing.. | 362,473 |
| Increase due to redemption of Series B, C and D bonds and issuance of Series E bonds.... | 294,552 |
| | <u>10,610,310</u> |
| Less: | |
| Reduction resulting from sale of transportation properties..... | 2,793,565 |
| | <u>7,816,745</u> |

A note keyed to the adjusted tax figure read:

"The amount shown above for Federal income taxes includes provision for estimated excess profits taxes of \$5,661,205 before reductions (1) as shown separately in the income statement and (2) of \$4,148,050 related to and applied against items charged directly to surplus, and after deducting estimated post-war credit of \$328,900."

¹⁸ The first amendment raised the amount of bonds being registered from \$33 million to \$59 million. This change required alteration of the amounts of some of the adjustments. However, the form of presentation was not changed from the original filing.

Finally, the \$609,949 adjustment relating to the emergency facilities was added back at the foot of the income statement just as was done in the certified statements.

The form of this *pro forma* statement of income was not criticized in the letter of deficiencies dated April 14 and no change was made by the second amendment. However, when the case was brought to us for directions, as noted above, we indicated that the same treatment should be accorded the *pro forma* statements as in the case of the certified statements.

In the third amendment, therefore, the *pro forma* statement was revised by eliminating the adjustment related to the emergency facilities, by reducing the initial and adjusted tax figures to the estimated amount of actual liability therefor, and by segregating the "special charges" so as to show them, in conformity with the certified statements after the third amendment, as a deduction from "Gross income (before special charges below)." The balance was entitled "Gross income (after special charges)." Note C was also revised to read:

"The amount shown above for Federal income taxes includes provision for estimated excess profits taxes (after deducting estimated post-war credit of \$100,356) of \$903,206 which is after reductions (1) of \$609,949 resulting from amortization of emergency facilities and (2) of \$4,148,050 related to and applied against items charged directly to surplus."

In the fourth amendment the form of the *pro forma* statement was again changed. A figure was now shown labeled "gross income" after which were shown three items; namely, the "special charges" of \$4,148,050; interest and amortization, \$2,409,075, and amortization of plant acquisition adjustments, \$693,168. These were deducted as a group from the gross income figure to give a balance labeled "Net Income." Note C was amended to add the following, "but does not give effect to tax savings of \$2,379,096 which are expected to result from the proposed refinancing."¹⁹

In our opinion, it would be most difficult to prescribe a rigid rule for the handling in "*pro forma*" statements of items such as are here in

¹⁹ This change is not germane to the present discussion which relates to the costs of a previous refunding.

issue. The difficulty is due very largely to the variety of situations dealt with under the name of "pro forma" statements. For example, that term has been used to describe estimates of future earnings when cast in the form of an income statement. It is also used, as here, to describe a statement in which the actual operations of some past period are altered or adjusted either to "give effect" retroactively to certain specific transactions which have since taken place, or to "give effect" to certain proposed transactions.²⁰ Where a *pro forma* statement reflects a straightforward estimate of future earnings, it would seem that the problem under discussion does not exist, since clearly any amount shown therein as taxes would be based on estimates of future tax rates and future taxable income. In such circumstances there would rarely, if ever, be any occasion for "charges in lieu of taxes" or "tax savings." Here the situation is different. The VEPCO "*pro forma*" statements are based on the actual statements for the year 1944. A limited number of adjustments to the actual figures are made to illustrate how certain specified events might reasonably be expected to have altered 1944 reports had such events occurred at the beginning of 1944. In this case these events are (1) the merger with Virginia Public Service on May 26, 1944 and the 1944 refinancing; (2) the sale of certain transportation properties during the year and (3) the proposed refinancing. On the other hand no retroactive adjustment was made as to a rate reduction which took effect on April 1,

²⁰ Rule 170 of the General Rules and Regulations under the Securities Act of 1933 prohibits the use of *pro forma* statements which purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash unless the sale of securities is underwritten and the underwriters are to be irrevocably bound, on or before the date of the public offering, to take the issue. Cf. Rule X-15C1-9 under the Securities Exchange Act of 1934.

1945. Such adjusted statements are, of course, useful to the extent they shed light on the future by illustrating the probable scope of the changes now being carried out. They are, accordingly, a hybrid form, being neither *statements of actual operations* nor thorough going *estimates of future earnings*. In the present case, the changes made are relatively few so that, on balance, the adjusted statements are much closer in nature to an actual statement than an estimate of earnings. For that reason, we feel that our views as to the certified statements are applicable to the adjusted statement under discussion. We point out again, however, that here as in the certified statements it is proper to add an appropriate qualifying phrase to such captions as "gross income."

V

THE FINDINGS AND OPINION OF THE COMMISSION
IN THE RELATED CASE UNDER THE PUBLIC
UTILITY HOLDING COMPANY ACT OF 1935

In their appearance before us the certifying accountants criticized certain data as to VEPCO that was included in our opinion in this case under the Holding Company Act.²¹ Under the caption "Earnings" we set forth the following:

"Attached hereto as Exhibit B is an income statement of VEPCO for the twelve months ended December 31, 1944 adjusted to reflect the merger of Virginia Public Service Company and the recent sale of transportation properties and *pro forma* to reflect the proposed refinancing.

"Gross income, interest and amortization, and pertinent ratios are as follows in Table IV.

²¹ In the Matter of *Virginia Electric and Power Company*, Holding Company Act of 1935 Release No. 5741, (April 20, 1945).

Table IV

| | Adjusted | Effect of refinancing | Pro forma |
|---|--------------|--------------------------|--------------|
| Gross income before Federal taxes on income..... | \$16,234,038 | ----- | \$16,234,038 |
| Federal taxes on income ¹ | 2,764,194 | \$294,552 | * 3,058,746 |
| Gross income..... | \$13,469,844 | \$294,552 | \$13,175,292 |
| Interest and amortization..... | \$2,740,710 | \$331,635 | \$2,409,075 |
| Ratio of gross income before Federal taxes on income to interest and amortiza- tion..... | 5.92 | ----- | 6.74 |
| Ratio of gross income to interest and amortization ² | 4.91 | ----- | 5.47 |

¹ Reflects reduction in 1944 taxes of \$2,091,177 resulting from redemption of bonds and \$2,058,873 resulting from loss on sale of property.

² Does not reflect additional reduction in taxes of \$2,379,096 to arise from payment of call premium in connection with the instant refunding."

The accountants pointed out that the ratios of gross income to interest and amortization were not at all representative of what might be expected for the future, since the provision for taxes was \$4,148,050 less and gross income \$4,148,050 more than they would have been had the refunding and sale of transportation properties not taken place. They further pointed out that under their proposal either to increase the amount shown for taxes by \$4,148,050 or to deduct a special charge of that amount before arriving at gross income the resulting ratios would be 3.40 and 3.75 before and after adjustment for the proposed refinancing. These ratios they believed were far more reliable indications of what might be expected for the future.

The materials included in our opinion show on their face the basis on which the ratios in question were computed. They are, in our opinion, a correct reflection of what occurred in the period. On the other hand, we agree with the certifying accountants that the current period was unusual to the extent at least of the three transactions under discussion.²² For that reason neither the current period nor ratios based on current results are fairly indicative of future possibilities. However, as will be pointed out in more detail later, we do not think the method of handling such a situation should be to alter or obscure the actual results of operation. Instead, we feel such a situation calls for a clear explanation of the circumstances. In this case, we feel that our opinion should have more graphically explained the situation by giving an additional set of clearly described ratios derived from the adjusted gross income figure referred to by the certifying accountants.

VI

THE TREATMENT OF "TAX SAVINGS" IN FINANCIAL STATEMENTS FILED WITH THIS COMMISSION

Cases involving the treatment of so-called "tax

²² It should be noted, however, that three of the 4 years from 1942 through 1945 are "unusual" by this test. In 1942 there were "Special charges" of \$1,571,158 in connection with a refunding in that year. In 1944, there were the \$4,148,050 "Special charges" in issue here. In 1945, it is estimated there will be \$2,379,096 "Special charges" due to the proposed refunding. Only in 1943 were there no "Special charges." For the 4 years average gross income was \$10,808,313 and average "Special charges" were \$2,024,567.

savings"²³ in financial statements have arisen with increasing frequency in recent months. For that reason, as stated earlier, we feel it desirable to state our views as to the treatment to be accorded such items in statements filed with us and to point out the reasons which have led us to those conclusions.

It is first necessary to state briefly certain of our general views as to the functions of financial accounting and the purpose of the income statement. In our opinion financial accounting is essentially historical in nature—it consists of an accounting for costs that have actually been incurred by the business and for the revenues that have been actually derived from the business. From a balance sheet point of view, the question is what part of past expenditures may still be treated as valuable assets, of benefit to future operations, and what part of such expenditures must be considered as having been used up or expired. In order to prepare an income statement, it is necessary to decide what part of the costs that have been incurred should be treated as expenses, and what part of the revenues obtained may be treated as income. Technically this process is sometimes spoken of as matching costs against revenues, the difference being, of course, profit or loss. The principal statement reflecting this matching up

²³ We think it undesirable in principle and possibly misleading to refer to this problem as involving "tax savings" although due to the general use of the term in this sense we have adopted the nomenclature here. It seems to us that the term "tax saving" is apt to connote some sort of standard or normal tax law and a standard or normal earnings year to which the law applies. The facts are, of course, that there has not been a static or standard or "normal" tax law or tax status; nor has it been possible except in most unusual cases to characterize any particular fiscal year of a company as a "normal earnings" year, from which all others are to be regarded as departures. Under such conditions, each year's tax is whatever happens to result from the application of the computation formula, provided by the tax law of that year, to the sum total of taxable transactions and tax deductions resulting from whatever business may have been done in that particular year. Moreover, the past few years during which the term and the problem of "tax saving" appeared have clearly been unusual in nearly every respect. Finally, if the phenomenon in question is to be described as a "tax saving" it would seem necessary to describe as a "tax loss" the failure to carry through a transaction which it can be said would have resulted in a "tax saving." And if taxes in one year are higher should not that increase itself be considered to be a "tax loss." Our strong preference is to describe the problem as involving "tax reductions."

process for a particular period is the income statement.

In order to arrive at a more precise matching of revenues and costs, accountancy has developed many procedures for handling particular transactions where the cost is incurred at one time and the benefit is received at another time, either earlier or later.

Much the same treatment is accorded cases in which a company receives revenue either before or after it delivers the goods or services contemplated. Ordinarily, such receipts will be treated as realized income, not necessarily in the year in which the cash is received, but rather in the year in which goods are delivered or in which the service is rendered or the costs of rendering that service are incurred.

It is also necessary as a part of this process of matching costs and revenues, for the purpose of determining income, to consider at appropriate intervals whether any amounts presently reflected as assets in the accounts should in the light of present conditions be written off or reserved against. Finally, consideration must be given to whether there exist contingencies for which provision should be presently made either by recognizing an actual, though perhaps estimated, liability, or by providing an appropriate reserve.

We have elaborated these underlying accounting assumptions in order to demonstrate further that financial accounting is in our opinion concerned with what did happen, not with what might have happened had conditions been different. And it does not attempt to forecast the future even though it supplies much of the material used in making such a forecast.²⁴

There is, on the other hand, another field of financial statistics in which statements are used which in form and language are closely similar to the financial statements used in presenting actual balance sheets and income statements. This is the field of financial analysis and forecasting. In

²⁴ Although we here emphasize the essentially historical character of financial accounting, it is by no means to be inferred that we feel the work done by the financial accountant is therefore mechanical or routine in nature. On the contrary, proper discharge of his duties and responsibilities presupposes that the financial accountant possesses and exercises an extremely high degree of professional skill, experience and judgment. We discuss this point further at pp. 87-88 *ff.*

essence, the analyst begins with reports of actual operations and conditions and adjusts them to give effect to expected future changes and events in order to arrive at his estimate of future earnings. In one form of analysis and forecasting the analyst is content to comment upon the actual past results, to point out what parts of the past results are due to factors which are not expected to continue and how the existence of new factors and conditions is expected to alter past results. At times, however, the analyst goes further and attempts to prepare an "adjusted" statement which purports to show how past operations would have worked out had certain specified subsequent events taken place earlier. Finally, the analyst may seek to forecast as accurately as may be what he expects will be the results of future operations. Frequently, in such cases, his forecast takes a form very like that used in portraying the results of past operations.

The validity of such analyses and forecasts, whether in the form of "comments," of "adjusted statements," or of "estimated future income statements," is clearly no greater than the soundness of the prophecies and estimates upon which they are based. The results shown, however, are meaningful to a reader only to the extent he is aware of and agrees with or understands the nature of assumptions and estimates made. In contrast to such forecasts, a statement of past operations, even though it is based in important part on opinion and judgment is primarily an historical record of actual events, not of prophesied future events.

The two types of financial statements are obviously in wholly different categories and have different uses in examining the investment merits of a security. Particularly because of the similarity in form, great care must be taken to ensure that the reader will be aware of the nature of the particular statement. Nothing, in our opinion, would be more misleading than to present, in the guise of an actual earnings statement, data which, in fact, was an estimate either of expected future earnings or of the effects of subsequent conditions and transactions on prior operations. The dangers inherent in the situation led us some years ago to adopt rules under the 1933 and 1934 Acts forbidding the use of "*pro forma*" statements unless a clear indication is given of the assumptions on

which they are based.²⁵ Also under the 1933 Act we have by rule prohibited altogether the use of "pro forma" statements in certain cases. Apparently with a similar appreciation of the danger of confusing actual and *pro forma* income statements the American Institute of Accountants has for many years included in its rules of Professional Conduct the following:

"12. A member or an associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast."

Notwithstanding the uncertainty inherent in estimates of future earnings, it is apparent that the formation of a considered investment judgment ordinarily involves a conclusion as to the future prospects of the company. It is necessary in the administration of the Public Utility Holding Company Act in arriving at a decision as to the propriety of a particular security in relation to the capitalization and earnings, or as to the fairness of the price at which securities or assets are proposed to be sold. Under the Chandler Act it is a necessary step in arriving at a conclusion as to whether a proposed reorganization is fair and equitable and feasible.

In reaching a judgment as to the future prospects of a company it is customary to begin with a statement of actual operations for an appropriate past period. Because of this use of actual statements of operations, an effort is ordinarily made to present the results of prior years' operations in a form that is as readily usable as possible for that purpose. In general, what is done is to segregate and earmark what are considered to be unusual and nonrecurring items of income, expense and loss so that the reader will be warned of them and so may arrive at a conclusion as to whether such items can be expected to recur. In addition, special treatment is accorded items of income or loss or expense that have been reported in the financial statements of 1 year, say 1943, but which by reason of later events or knowledge, are now known to have been actually part of the costs or revenues applicable to another year, say 1942. In such cases, it is customary in filing comparative statements

for the 2 years to include such items in the year to which they are now known to be related. Such adjustments are in our opinion entirely proper and ordinarily desirable provided, of course, that appropriate disclosure is made so that the comparative statements can be reconciled with the 1942 and 1943 statements as originally issued. Finally, disclosure should be made as to significant, known factors that might render past earnings statements, or particular items therein, not indicative of probable future operations.²⁶ With such information at hand the reader of the statement is informed of what the past operations were, and of the conditions or transaction, which in the draftsman's judgment, are apt to be unusual and not apt to recur. In our opinion, this is the boundary line of financial accounting. It is the place at which the financial accountant in his capacity as such should stop. He is, we feel, essentially a historian, not a prophet.

²⁵ In our opinion *In the Matter of The Colorado Milling & Elevator Company*, 15 S.E.C. 20 (1943) we had occasion to emphasize the need for disclosure of major changes in financial and operating factors that rendered statements of past earnings not fairly indicative of what might be expected for the future. In that case the registrant had disposed of a large investment portfolio the income from which had of course been included in past earnings statements, had used the proceeds of this sale and of a \$2 million bank loan to pay an extraordinary cash dividend of \$7 million and now proposed to issue some \$3 million of new 4 percent debentures. It had entered into new agreements for lines of bank credit at a much higher interest rate. Finally it had materially increased the rate of management compensation and had determined to extend its insurance coverage at a material increase in the amount of insurance premiums payable. In view of these significant changes in financial and operating factors and their material effect on the future earnings of the company we said:

"The net effect of the foregoing will be to diminish the net income available for dividends. Profit and loss statements are required in the registration statement as an indication to prospective investors of the registrant's earning power. The 9-years' profit and loss statement contained in this registration statement reflected the results of operations during a period when the registrant had maintained continuously a financial status substantially equivalent to that existing immediately prior to this financing. By reason of the changes effected since May 22, that financial status bears little resemblance to that which obtains presently. Where such changes will have a material effect on prospective earnings, the omission to disclose those changes and their effect with relation to the profit and loss statements is as misleading as if the registrant's past earnings had been misrepresented."

²⁶ *Supra*, n. 20.

This desire to prepare statements in a form more readily usable in estimating the future has led some to attempt to present what can be called a "normal" income statement, the inference being that the statement shows about what can be expected to happen year after year. The broad justification alleged for the practice is that if the actual results of the year's operations are unusual a reader may be misled into thinking the abnormalities will recur and that the best, if not the only way, to avoid such misconceptions is to "normalize" the statement—that is, to exclude therefrom the effects of some or all of the conditions which in the opinion of the draftsman are deemed to be unusual.

The dangers inherent in such a practice are numerous. In the first place, the draftsman's judgment as to what is abnormal can scarcely be considered infallible. In the second place, there is certainly as much danger that the reader will fail to understand what has been done by the draftsman as that he will fail to recognize that the unadjusted statements are abnormal. Finally, the method is extremely susceptible of misuse through conscious or unconscious bias in making decisions as to what is unusual or abnormal about the current year. To a degree, of course, the care with which disclosure is made of the extent of normalization may serve to minimize the possibility of misleading the reader. But in general we are satisfied that a statement purporting to reflect the actual results of operations is far less likely to be misleading if abnormalities are explained than if they are eliminated by adjustment in the statement even with an explanation of the elimination set forth in a note.²⁷ If, of course, a clear and full explanation of the adjustments made is not given, the practice is highly deceptive and may be fraudulent. It may be noted in passing that accountants have long condemned such undisclosed "adjustments" terming them at times a device akin to "equalizing earnings."

We conclude, then, that the proper function of an income statement presenting the results of operations is to present an accurate historical

²⁷ Where the tax provision is presented as in the original VEPCO statements or a charge in lieu of taxes shown, we doubt whether any but the most experienced reader of financial statements would be apt or perhaps able to make the calculations necessary to arrive at the amount of net earnings or of net earnings per share based on the actual tax payable.

record. On this basis, it is evident that the items included therein should clearly and accurately reflect only actual operations. It is accordingly our view that the amounts shown should be in accordance with the historical facts and should not be altered to reflect amounts that the draftsman considers to be more "normal" or likely to recur in future years.²⁸

We return now to the particular problems presented by the facts in the VEPCO case. In their appearance before us the certifying accountants objected to our position and defended their proposal on three principal grounds:

(1) That as an accounting matter it is necessary to "allocate" the actual taxes as between charges to surplus and income from operations, even if that practice results in the inclusion in the income statement of a charge (described as taxes or as charges in lieu of taxes) in excess of the actual taxes payable, with an offsetting "credit" or "negative tax" being carried to surplus in amount sufficient to reduce the charge on account of taxes to the amount actually payable.

(2) That the adjustment of the tax figure, or the inclusion of a charge in lieu of taxes in or on a parity with operating expenses, results in the income statement being more useful to investors since it is more nearly indicative of "normal" conditions and probable results in the future.

(3) That in the setting of rates for regulated public utilities it is proper to base future rates on expected future taxes, hence the adjustment method tends to conform the income statement to the basis on which the rates of the company will be set.

For convenience, we shall first discuss the latter two points leaving the allocation argument until

²⁸ We do not at this time propose to discuss the practice of treating certain types of losses and income as corrections of surplus rather than as elements of profit and loss to be reflected in the year's income statement. That question is involved in certain proposed amendments to Rule 5-03 of Regulation S-X which have been distributed for comment to interested persons. The comments received have not yet been fully analyzed, and it is likely that further steps will be taken to develop the nature of the problem and any conflict of opinion as to its proper solution. We feel it inappropriate in this statement to seek to anticipate the outcome of that investigation.

last. The second contention we believe to be unsound for the reasons stated in our general discussion of the functions of financial accounting and of income statements reflecting the results of past operations. We think such statements should be historical records of the results of whatever financial events actually took place. It is not the role of the financial accountant to adjust them so as to eliminate the effect of unusual circumstances which actually occurred. Accordingly, we cannot agree with this contention. To include under operating expenses as taxes an amount which is not taxes because the substituted amount is considered by the draftsman to be "normal" is precisely the type of adjustment which we believe unsound in a statement of actual operations. And if the amount of the adjustment is undisclosed the statements are deceptive to a point that may border on fraud. If the fact of adjustment be disclosed but not the amount, the statements are still misleading in our opinion and, at the very best, are useless as reports of actual operations.

There is a related difficulty. If the "credit" to surplus or "negative tax" figure offsetting the enlarged charge to income is netted without disclosure against the loss or expense charged to surplus, the reader will be unable to determine the actual amount of the loss or expense in question. In our opinion such an event as the sale of corporate property at a substantial loss is an important fact. It is no less important because, fortuitously or intentionally, one of these events occurs in a year of high tax rates and high income so as to effect a substantial reduction in the income taxes payable. There are in these cases *two* facts to be disclosed—the loss on the property, and its tax consequences. Such a transaction ought to be reported in such a manner as not to conceal either the fact that a loss was suffered or the amount of the loss. To report this kind of loss net of its tax consequences is no more supportable in our judgment than to report on a similar net basis an expense such as advertising, depreciation, interest or any other item in the income account.²⁹

²⁹ It will be noted that an income statement which is charged only with the estimated amount of taxes actually payable thereby reflects the tax reduction due to special items. Moreover, the benefit of the tax reduction will be reflected in earned surplus, the amount of which will ultimately be the same whichever of the several suggested treatments of these tax reductions is followed.

The third argument advanced in support of the enlarged charge to taxes, or of the charge in lieu of taxes, is that the income tax figure which is a significant factor in respect of the rates of a regulated public utility is not the actual amount of taxes paid but the amount that would have been payable but for the loss or expense carried to surplus. This argument is, of course, limited in its application to public utilities whose rates are subject to governmental regulation. Such companies are ordinarily required to follow a uniform system of accounts and, in most jurisdictions, the prescribed form of income statement shows income taxes as an element of operating expenses, or as is sometimes said "above the line." Generally speaking, items included "above the line" are recognized as expenses allowable in computing the gross income for rate purposes whereas deductions made "below the line," such as interest, and items carried to surplus are not chargeable in this way.³⁰

³⁰ The deductibility of income taxes in computing return for rate purposes was an issue in *Galveston Electric Company v. Galveston*, 258 U.S. 388, 42 Sup. Ct. 361 (1922). There the Supreme Court speaking through Mr. Justice Brandeis said "All taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between State and Federal taxes or between income taxes and others." This position was reaffirmed in *Georgia Railway & Power Co. v. Georgia Railroad Commission*, 262 U.S. 625, 43 Sup. Ct. 680 (1923). These decisions dealt only with the normal income tax then in effect. Therefore, because of certain observations by Justice Brandeis there are those who argue that these decisions may not be controlling as to the present Federal tax, particularly the present excess profits tax. Thus, in the *Galveston* case the court took care to point out that under the tax law then in effect the stockholder did not have to include dividends received from the corporation in his income subject to the normal Federal income tax and that this tax exemption was therefore, in effect, part of the return on his investment. Under the current tax law such dividends are taxable to the recipient. The court also said: "But the fact that it is the Federal corporate income tax for which deduction is made, must be taken into consideration in determining what rate of return shall be deemed fair."

The Supreme Court has not yet had before it a case involving the deductibility for rate purposes of an excess profits tax actually paid by the company. Some question as to its deductibility is, however, raised by the language used by Mr. Justice Douglas in his dissenting opinion in *Vinson v. Washington Gas Light Co.*, 321 U.S. 414, 64 Sup. Ct. 731 (1944). He there said, in discussing a provision of the Stabilization Act of 1942 which prohibits any "utility" from making "any general increase in its rates or charges which were in effect on

September 15, 1942" without giving the Director of Economic Stabilization the right to intervene in the proceedings.

"I believe, moreover, that when Congress halted general rate increases and gave the Director a right to intervene it did not sanction rate increases regardless of need and regardless of inflationary effect. I think it meant to make utility commissions at least partial participants in the war against inflation and gave them a sector of the front to control. Though it did not remove the established standards for rate-making, I do not think it intended utility commissions to proceed in disregard of the requirements of emergency price control and unmindful of the dangers of general rate increases. To the contrary, I think Congress intended that there should be as great an accommodation as possible between the old standards and the new wartime necessities. The failure of the Commission to make that accommodation is best illustrated perhaps by its treatment of taxes. The Commission allowed the company to deduct as operating expenses all income taxes up to and including 31 percent. That this amount includes wartime taxes is evident from the fact that the highest corporate tax rate which prevailed from 1936 to 1939 was 19 percent. We all know that the extraordinary expenditures incurred for the defense of the nation started with the Revenue Act of 1940. It has been accepted practice to deduct income taxes as well as other taxes from operating expenses in determining rates for public utilities. *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 399. But this is war, not business-as-usual. When income taxes are passed on to consumers, the inflationary effect is obvious. And it is self-evident that the ability to pass present wartime income taxes on to others is a remarkable privilege indeed."

In *Detroit v. Michigan Public Service Commission*, 308 Mich. 706, 14 N. W. (2d) 784 (1944), the Michigan Supreme Court held, three Justices dissenting, that the *Galveston* case did not control the treatment in rate cases of the present Federal excess profits taxes. Writing for the majority, Justice Bushnell said, "As I read *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 399, 66 L. ed. 678 P.U.R. 1922 D 159, 42 S. Ct. 351, which is intimated by my brother as controlling, its authority is limited to normal taxes and not to abnormal and avoidable taxes on "excess profits" even though it must be conceded that the term by which such tax is designated is a misnomer. Excess profits are a question of fact for determination by the Commission."

A similar result was reached by the West Virginia Supreme Court in denying the deductibility of the excess profits taxes levied during the first World War. *Charleston v. Public Service Commission*, 95 W. Va. 91, 120 S. E. 398 (1923).

In its decision in *City of Detroit v. Panhandle Eastern Pipe Line Co.*, 3 F.P.C. 273 (1942), the Federal Power Commission, at p. 291, expressed its objection to the allowance of excess profits taxes in computing returns as follows:

"Thus it appears that the doctrine of unjust enrichment as well as equity and good conscience compel the conclusion that a utility should not be permitted to thwart the purpose and spirit of the war price control legislation and the revenue laws by passing such abnormal tax requirements along to its consumers as an operating expense to be collected in increased rates. Indeed, we feel increased rates on such a basis

The short answer to this contention is that in most, if not all cases, the required systems of accounts do not permit a charge to operating expense accounts except for expenses actually incurred.³¹ We note that the Committee on Statistics and Accounts of the National Association of Railroad and Utilities Commissioners has,

would be unjustifiable. To allow them would in effect impose upon the consumers a sales tax.

"So that there may be no confusion concerning the tax situation in connection with the companies subject to our jurisdiction, where necessary to stabilize utility rates at reasonable levels during the war emergency period, we propose to allow as proper operating expenses only such taxes as may be termed ordinary or normal. For the purpose of distinguishing between ordinary or normal and war emergency or abnormal taxes, we conclude that the basis prescribed in the 1940 Revenue Act establishes the highest possible level of Federal taxes which may be allowed as an element of operating expense for such purpose. The 1941 Revenue Act and the pending 1942 proposal certainly reflect abnormal tax requirements for war purposes."

The Federal Communications Commission in *Re Investigation of Rates and Charges*, 50 P.U.R. (NS) 468, 489 (1943) also disallowed a deduction for excess profits taxes. The trend of a number of state utility commission decisions seems to be to limit or deny the deductibility of excess profits taxes. See *In Re Los Angeles Gas & Electric Corporation*, P.U.R. 1922 A, 283 (California); *Re Western States Gas and Electric Co.*, P.U.R. 1919 B, 485, 493 (California); *Re Vallejo Electric Light & Power Co.*, 55 P.U.R. (N.S.) 435, 443, 454 P.U.C. v. *Springfield Gas & Elect. Co.*, 53 P.U.R. (N.S.) 95, 105 (1944) (Missouri); *Re Washington Gas Light Company*, 53 P.U.R. (N.S.) 321, 327, 336 (1943) (District of Columbia); *Re Northern States Power Co.*, 55 P.U.R. (N.S.) 257, 273 (1944) (North Dakota). Cf. *Re British Columbia Electric Railway Company, Ltd., et al.* 53 P.U.R. (N.S.) 438, 464 (1943) (British Columbia). An excess profits tax which had been neither reported to the government nor paid was not allowed as a deduction in *P.S.C. v. Utah P. & L. Co.*, 50 P.U.R. (N.S.) 133, 167 (1943) (Utah). But see *Pfeife v. Pennsylvania Power and Light Co.*, 57 P.U.R. (N.S.) 1, 32 (1945) (Pennsylvania); *San Antonio Pub. Service Co. v. San Antonio*, P.U.R. 1924 A, 259, 263 (Texas); *Detroit v. Detroit Edison Company*, 50 P.U.R. (N.S.) 1, 3 (1943) (Michigan).

In the instant VEPCO case it will be noted that the registrant's computations as to the tax effect of the special items resulted in an adjustment of excess profits taxes only; no adjustment of normal taxes is indicated. See Exhibits A-D.

³¹ Under our Rule U-28, moreover, a registered holding company or subsidiary company thereof is forbidden to "distribute to its security holders, or publish, financial statements which are inconsistent with the books of account of such company or financial statements filed with this Commission by, or on behalf of, such company."

in Case E-80, so interpreted the N.A.R.U.C. classification.²²

We think, moreover, that this contention of the accountants in this case is unsound on its face. The costs and expenses, including interest, that arise from the borrowing of capital are almost universally excluded from the computation of gross income for rate making purposes. To include in operating expenses by indirection an item which is specifically excluded therefrom is obviously improper. Yet this is what is here proposed. The credits, in this case, that offset the charge in lieu of taxes have been deducted from the refunding expenses and the loss on sale of transportation properties, respectively, so that the charge to surplus is a net charge. To include in operating expenses part of the refunding expenses either directly or in the guise of a special charge in lieu of taxes is a violation of the premise that the costs of borrowing money are not a deduction in computing return for rate purposes. It would be as logical to say that the interest paid in a given period reduces the income tax payable and that therefore a charge in lieu of taxes should be included above the line with an offsetting reduction in interest expense below the line.

Finally, this contention seems to us to misconceive the relation of past results to the process of rate making. Where rates are being set for a future period, it is obvious that the actual results of past operations are only indications of what may be expected to be forth-coming in the future. The

²² Case E-80 reads as follows:

"Question:

Several utilities which have refunded bond issues, have had substantial tax savings in the year the refunding occurred, because the unamortized debt discount, expense and call premium associated with the refunded securities is permitted as an income tax deduction during the year redeemed. Instead of showing the actual taxes paid or accrued in the tax account, the utilities in question have also included therein the amount of the tax savings due to the refunding operation with an offsetting credit usually to Account 140, Unamortized Debt Discount and Expense. Is this permissible?

"Answer: No

The tax account (507) should include only provision for actual taxes and the account should not be increased by the amount which would have been paid had the refunding transaction not occurred. In other words, there was an actual saving in taxes and this saving should be reflected in the income statement because it is a fact. It is believed, too, that the text of Account 507 does not permit the accounting practice resorted to by the utilities in the illustration cited."

problem is, broadly, to determine what future earnings may be expected to result from particular rate structures. Consequently, it is customary to "adjust" many of the past operating expenses to bring them into line with present or anticipated conditions. Among such conditions are, of course, future taxes and tax rates. Accordingly, in the approximations made of future expenses there would be included not the actual taxes of the past year, or even what the taxes would have been had there been no unusual transactions such as a bond refunding, but instead an amount equivalent to what the income tax will be in the future in view of the assumptions made as to future income and future tax rates.²³ The amount of past taxes would be used only if, after examination, it was concluded that tax rates and future income were not expected to change.²⁴

The rate making process is thus not unlike the formulation by the investor of his judgment as to the future prospects of the company. In both cases, reports of actual past operations are used as a

²³ In *State v. Public Service Commission*, 336 Mo. 860, 81 S.W. (2d) 628 (1935) the court held that only taxes actually payable need be considered: "The ninth and last point urged in appellant's brief is that 'the Commission's action in refusing to allow the inclusion of Federal income taxes as operating expenses was error.' The undisputed evidence is that the company did not pay income taxes. We are not aware of any authority holding that in such case an allowance of this kind should be made, and counsel for appellant cite none." See also *Re East Ohio Gas Company*, 17 P.U.R. (N.S.) 433, 445 (1937). In *Public Service Commission of Utah v. Utah Power & Light Company*, 50 P.U.R. (N.S.) 133, 167 (1943) the company had sought to justify the reasonableness of certain rates by including \$1,480,000 of "computed" excess profits taxes in operating expenses. In fact the company neither reported on its tax returns nor paid any excess profits tax. This "computed tax" item thus resembles very closely the so-called "tax savings" in question here. The Utah Commission disallowed the claimed deduction saying: "The injustice to Utah rate payers is obvious when excessive rates and earnings are made to appear to be reasonable by means of computed excess profits taxes which have not been paid or reported to the government. We reject the company's claim that its computed (but not reported or paid) excess profits taxes should be included in the cost of service and thus passed on to the rate payers." * * *

²⁴ Where a "sliding scale" formula is in operation, the actual results of current operations, including taxes, are determinative of future rates. In such a case there would, it seems to us, be danger of grave injustice in applying the formula to the results of actual operations for the year which, however, reflected a deduction based on income taxes that were neither paid nor payable by the company.

starting point. In both cases, these actual statements are analyzed to determine the extent to which they may be relied on as indicative of the future and, where necessary, appropriate adjustments are then made. Except that the possibility of misleading the reader is very largely absent when the user is a rate making body, the comments we have made earlier as to *pro forma* statements are applicable here—and with this addition that the judgment of the draftsman as to what is the normal or proper amount of taxes is less important, since for rate purposes the judgment of the rate making body on this point will generally be conclusive.

We come next to the remaining contention urged by the certifying accountants, that as a matter of correct accounting it is necessary to "allocate" income taxes to income and other accounts. This theory is also advocated and developed in detail in a bulletin, "Accounting for income taxes" issued in December 1944, by the Committee on Accounting Procedure of the American Institute of Accountants.

There is no doubt that allocation is a basic accounting procedure. In fact the whole process of preparing income statements is a species of allocation—of determining what revenues are allocable to the current income account and what expenditures are properly to be treated as costs allocable to the current income account. It is not therefore a demonstration of the merit of the proposed device to describe it as an allocation or to say that income taxes should be allocated. Whenever an item is charged to income, or indeed when it is excluded and carried as an asset, "allocation" in the accounting sense has taken place. The issue here is not whether income taxes should be allocated but whether the treatment of income suggested by the accountant's third contention is preferable to the method of allocation heretofore followed—that is, to show as a deduction from income of the current year the income and excess profits taxes which are believed to be actually payable, under the applicable tax law, as taxes of the current year.

In the argument before us and in the bulletin mentioned it has been urged that income taxes are an expense that should be allocated as other expenses are allocated. In neither case, however, was there any effort made to state the reasons why Federal income taxes must be considered as an

expense in the same category as, let us say, wages. It is obvious, of course, that the net profit applicable to stockholders cannot be determined without first making an appropriate allowance for the amount that must be paid as income taxes. However, this fact does not dispose of the question. It is readily apparent that normal and excess profits taxes are computed as a *part of* taxable net income. Unlike most expenses they exist if, and only if, there is net taxable income before any deduction for such taxes. There is much to be said therefore for the position that true income taxes are in the nature of a share of profits taken by the government. If it is desired to place emphasis on the necessity of deducting them in order to arrive at net profit available to shareholders, they may perhaps be called an expense—but in such case they represent a very special class of expense, one that is incurred only by the making of a net taxable income.

Accordingly, to the extent that the propriety of the proposed treatment of income taxes depends on their classification as an expense rather than a share in profits we feel that the case remains unproven. Even if they be so classified, we feel that in view of their unusual and distinctive characteristics the propriety of the proposed treatment is not demonstrated merely by classifying them as an expense and then concluding that for that reason they should be allocated as other expenses are allocated.

We now examine the contention that income taxes should be allocated "as other expenses are allocated." The accountants who appeared before us cited to us no other expense which, for general accounting purposes, is allocated in the manner proposed for income taxes, nor have any such instances otherwise come to our attention. We note, moreover, that in a dissent to the bulletin mentioned earlier it was stated:

"No expense other than Federal income and profits taxes is allocated on the basis of applying to a given transaction so much of the expense as would not have occurred if the transaction to which the expense is attributed had not taken place. The usual method is to allocate a total expense ratably to given accounts or transactions on a consistent basis."

The illustrations of expense allocation cited to us by the certifying accountants in this case

appear to us to support the above statement. In each case cited there was an expense actually incurred that was first allocated to the period under the usual accrual principles and then distributed over a number of accounts. In no case was there an estimate made of what the expense would have been under other conditions. In no case cited, was there a distribution of an expense to several accounts by means of what can be termed an algebraic formula in which a negative sum is credited against one item to offset the positive charge to another item of an amount in excess of the actual expense. We do not regard such a treatment as an appropriate means of allocating income taxes in financial statements which purport to reflect the actual results of operations. We have doubt indeed that such a method can properly be termed an allocation at all, as that term is customarily used.

We note, in passing, moreover, that in the examples of expense allocation cited to us there existed a direct, almost physical association between the item being allocated and the item to which it was charged. For example, in the case of real estate taxes allocated to construction the tax item is directly and closely related to the construction. Likewise, in the case of brokerage fees, and stamp or transfer taxes, the tax item is closely and directly related to the specific transaction. *In both cases, moreover, the tax is independent of any other transactions of the company.* Nor is there any attempt made to increase in the course of the allocation the amount of such taxes to an estimated sum. We feel therefore that such illustrations cannot properly be cited in support of the proposed treatment for income taxes.

It is also sometimes pointed out that "cost" in the case of securities or property acquired is generally considered to be the sum of the purchase price plus incidental costs such as brokerage and any specific taxes paid by the buyer and that on sale the proceeds are computed as the selling price less incidental deductions such as commissions or any specific taxes paid by the seller. By analogy and in justification of the proposed treatment of income taxes it is frequently urged that a so-called "tax saving" must be allocated or attributed to or ultimately associated with particular losses or expenses because the tax consequences of the transaction involving the loss or expense were a motivating factor in arriving at the decision to

consummate it. Thus, it is claimed that a property would not have been sold out but for the "tax saving" thereby effected and that for this reason it is proper to consider that the true "loss" on the sale is not the excess of cost over selling price but is equal instead to the difference between cost on the one hand and selling price *plus* "tax saving" on the other. We do not believe such an analogy is sound and we cannot accept that analysis as a basis for reporting the results of actual operations. It is undoubtedly true that the tax consequences of selling a property often are an important consideration in arriving at the decision to sell, and may in some cases have been a deciding factor. However, tax consequences undoubtedly play an important role in the making of a great variety of decisions involving the incurrence and amounts of purely operating expenses such as advertising, wage rates and bonus plans. Yet it can hardly be argued that wages or bonuses or advertising are to be reported as less in amount because income taxes would have been higher if the amounts spent on such items were less. We see no basis for adopting a different approach in figuring the "loss" involved in sale of property. We feel instead that there has been a loss of the full difference between cost and selling price coupled with a tax benefit which is properly reflected in the lower taxes actually paid. We feel that the proposed treatment of income taxes tends to obscure these facts and that the treatment of income taxes required by our rules and heretofore almost universally followed clearly discloses what has taken place. Where the tax paid for the year is unusual in amount because of unusual conditions, an appropriate explanation would be called for as is now required in the case of other unusual events.

As to this last principal contention urged by the certifying accountants (that income taxes are an expense that should be allocated as other expenses are allocated) we feel, first, that there is grave doubt whether income taxes can properly be considered as an expense in the same category as the cost of materials or wages, and, second, that the treatment proposed does not result in the allocation of income taxes "as other expenses are allocated." We feel instead that the proposed treatment is purely an effort to have items shown in the income statement at what is considered to be a "normal" amount. We note that this objective is clearly expressed as a prime purpose of the

method in the bulletin referred to earlier, which states at p. 185:

"As a result of such [unusual] transactions the income tax legally payable may not bear a *normal* relationship to the income shown in the income statement and the accounts therefore may not meet a *normal* standard of significance." (Emphasis supplied)

There are, finally, a number of difficulties involved in the proposed treatment of income taxes that deserve mention even though they are not directly related to the specific contentions put forward by the certifying accountants in the case.

The first involves the preparation of general statistical data from financial reports. Under the method proposed, it is permissible to show, as taxes, an amount in excess of the taxes payable. If such items are totaled for a period of years or for groups of companies, they may well be used as evidence of the aggregate amount of taxes paid by the company or by the industry. Obviously any such representation is erroneous and will misstate, often very materially, the underlying facts. We feel that we should not permit the filing with us of income statements which readily permit, if they do not actually invite, such misuse. Even a "charge in lieu of taxes" may result in distorted overall statistics since it operates to reduce net income after taxes and so affects the ratio of actual taxes to net income. If the offsetting credit is netted against a surplus charge the distortion may be permanent.³⁵

³⁵ Under one variant of the practice no change is made in *final net income*. In the statements originally filed in the instant case, for example, part of the amount included as a charge among the operating expenses represented a \$609,949 reduction in income taxes due to the taking for tax purposes of accelerated amortization of emergency facilities at the rate of 20 percent a year while in the financial statements only normal depreciation was being accrued. See p. 77 *supra* and Exhibit A. In the original statements this \$609,949 was added back as the last item in the account. This internal in-and-out treatment appears to us to suffer from all of the difficulties we have discussed even though no change results in the amount of "net income." In our opinion, an overstatement of operating expenses is not corrected by "adding back" the amount of the overstatement at a later point in the income statement. Such treatment is in our view artificial and deceptive to all but the most experienced reader. While there may be some grounds for crediting such reductions in taxes to a special amortization reserve there is none for the equivocal practice here followed.

The second and somewhat technical problem is the difficulty of the computation. It is usual in contemplating the tax consequences of a proposed transaction to treat it as an incremental or marginal item. Where tax rates are graduated, this results in associating the marginal income or expense with the highest tax bracket. It is questionable whether such a principle is realistic when applied to the results of operations for a completed year. Net taxable income is a composite of all taxable income and all deductible items applicable to the period. The propriety of singling out any specific item as the item which is taxed in the highest tax bracket is doubtful. Moreover, in applying the theory to losses and expenses it would appear that the existence of a reduction in taxes is due not only to the expense but is equally dependent on the existence of taxable income to offset the expense. It would appear possible that some part of the benefit from the "reduction" ought to be attributed to the existence of income.³⁶ Even if this point be waived, however, there has been no satisfactory analysis presented of the effect to be given to the carry-back, carry-forward provisions of the present income tax law. Without exploring all of the possible difficulties, one case may be cited. Suppose that a loss has been charged to surplus but is deductible for taxes. Suppose further that in accordance with the present proposal there is charged to income, as provision for taxes, the amount of \$200,000 although the actual tax amounts to only \$50,000. If in the next year the company suffers an operating loss of \$500,000, then in view of the carry-back provisions the reader of the two income statements would reasonably expect to find a carry-back refund of \$200,000—the amount shown as taxes in the first year. However, obviously no more than \$50,000 would actually be refundable. The question arises

³⁶ We note the customary solution of a somewhat similar problem that arises when a group of companies files a consolidated tax return. In assigning to each constituent its fair share of the consolidated tax paid by the group it is usual to divide the actual tax among the companies who would have had to pay tax on an individual basis. If one of the included companies operated at a loss, the consolidated tax is of course reduced, but no part of the "saving" is ordinarily paid over to the loss company by the other members of the group. Instead, only those *contributing* income to the consolidated return share directly in the benefit of the current reduction. This principle is incorporated in our Rule U-45 under the Public Utility Holding Company Act.

whether having overstated taxes in the first year it is not necessary, to be consistent, to overstate the refund in the second year. Finally, there are the permutations in the computation where a company pays taxes as a member of a consolidated group. In addition to the allocation of the actual tax paid among the several companies in the group, the proposed treatment raises the difficult question of whether the amount of the so-called "saving" is to be computed on the basis of a company's individual status or on that of the consolidated group and, once this is decided, of whether to allocate this "saving" as between the several companies or attribute it solely to the company having the deduction—even though perhaps it itself contributed no taxable income!

The third difficulty is the propriety of singling out the income tax item for adjustment on the ground that it does not bear a "normal" relation-

ship to the income reported. Particularly, under conditions like the present, many if not most of the income and expense items bear unusual relationships to each other. Under the influence of the war sales volumes are often very high. Maintenance may be very high due to continuous operation of the plant, or very low because of the inability to obtain materials and labor, or very high because of the use of inexperienced labor and the inability to get new machinery, or very low because operations cannot be stopped long enough to make thorough-going maintenance possible. Selling costs may be very low because of the volume of war business or very high because of the use of advertising to keep restricted products in the public's mind. With many items of income and expense apt to be out of line, there appears to be little justification and a good deal of danger in singling out one item for adjustment.

EXHIBIT A

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined—Condensed certified statement of income for 1944 as shown in original registration statement and after amendment No. 1^a

| Item | Amount |
|---|--------------|
| Operating revenues..... | \$51,681,778 |
| Operating Expenses and Taxes: | |
| Other than taxes..... | 28,237,367 |
| Taxes, excluding reductions shown separately below or applied against items charged directly to surplus: | |
| Federal income (Note C). ^a | 2,139,496 |
| Federal excess profits (Note C). ^a | 8,164,872 |
| Post-war credit..... | (351,082) |
| Other..... | 4,131,408 |
| Total..... | 42,322,060 |
| Net operating revenues..... | 9,359,718 |
| Other income..... | (45,359) |
| Gross income..... | 9,314,359 |
| Deductions from income: | |
| Interest and amortization, etc..... | 3,719,527 |
| Net income..... | 5,594,832 |
| Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed throughout their normal life and not to replace existing facilities..... | 609,949 |
| Balance transferred to earned surplus..... | 6,204,781 |

^a Note C to the income account as set forth in the registration as originally filed read as follows:

"C. Federal Income and Excess Profits Taxes

"Virginia Public Service Company and Subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring deductions in computing the amount of 1942 taxes payable amounts to \$1,571,158 and an equal amount has been deducted in the accompanying statements of income for 1942 as special amortization of debt discount and expense. The balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942 was charged against earned surplus.

"However, the taxable net income as computed did not reflect the deduction, for tax purposes, of losses upon sales of ice and railway property, and certain other items charged to surplus. As a result, provisions charged to income in 1942 were approximately \$330,000 in excess of the company's liability for Federal income taxes as shown in its tax return for that year. Pending review of the returns, this excess provision is included in accrued Federal income and excess profits taxes at December 31, 1943.

"In 1943 the company filed a claim for refund of 1941 Federal taxes in the net amount of approximately \$297,000 under the carry-back provisions of the 1942 Revenue Act. However, this amount is subject to such adjustments as may result from review by the U.S. Treasury Department and

the claim has not been recorded upon the books of the company.

"Federal income and excess profits tax returns for the company and its subsidiaries for years prior to 1942 have been examined by the Treasury Department and those for the years prior to 1941 have been closed, except for the year 1937 in respect of which a claim for refund is pending."

First Amendment:

The following paragraph was added to Note C:

"Virginia Electric and Power Company—In addition to the reduction in Federal taxes on income shown in the income statement for 1944, reductions in excess profits taxes aggregating \$4,148,050 have been applied against items charged directly to earned surplus."

The first paragraph of Note C as above quoted was also modified to reflect an amendment to the form of the profit and loss statement for Virginia Public Service Company. As amended the paragraph reads as follows:

"Virginia Public Service Company and Subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed without the benefit of the deduction of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring deductions in computing the amount of 1942 taxes payable amounts to \$1,571,158 and an equal amount has been deducted in the accompanying statements of earned surplus for 1942 from the balance of unamortized debt discount and expense, call premium and duplicate interest on long-term debt called for redemption in 1942."

EXHIBIT B

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined—
Condensed certified statement of income for 1944 as shown in amendment No. 2

| Item | Amount |
|---|--------------|
| Operating Revenues..... | \$51,681,778 |
| Operating Expenses and Taxes: | |
| Other than Taxes..... | 28,237,367 |
| Taxes: ^a | |
| Federal income ^b | 2,139,496 |
| Federal excess profits ^b | 3,406,871 |
| Post-war credit..... | (351,082) |
| Other..... | 4,131,408 |
| Total operating expenses and taxes before special charges..... | 37,564,061 |
| Special charges equivalent to reduction in Federal excess profits taxes resulting from special amortization of emergency facilities (reduction shown separately below) and from redemption of bonds and sale of property (reductions applied against related items charged to surplus)..... | 4,757,999 |
| Total operating expenses and taxes including special charges..... | 42,322,060 |
| Net operating revenues..... | 9,359,718 |
| Other income..... | (45,359) |
| Gross income..... | 9,314,359 |
| Deductions from income: | |
| Interest and amortization, etc..... | 3,719,527 |
| Net income..... | 5,594,832 |
| Reduction in Federal income and excess profits taxes resulting from the amortization of facilities allowable as emergency facilities under the Internal Revenue Code, which facilities are expected to be employed throughout their normal life and not to replace existing facilities..... | 609,949 |
| Balance transferred to earned surplus..... | 6,204,781 |

^a The language "excluding reductions shown separately below or applied against items charged directly to surplus" included in original registration and Amendment No. 1 was deleted from this caption by Amendment No. 2.

^b Federal income and excess profits taxes.

Note C to the income account as shown in the registration as originally filed after Amendment No. 1 was changed by Amendment No. 2 as follows: The paragraph added by the first amendment was deleted. Also the first paragraph of the original Note C was deleted.

EXHIBIT C

*Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined—
Condensed certified statement of income for 1944 as shown in amendment No. 3*

| <i>Item</i> | <i>Amount</i> |
|--|---------------|
| Operating revenues..... | \$51,681,778 |
| Operating Expenses and Taxes: | |
| Other than taxes..... | 28,237,367 |
| Taxes: | |
| Federal income (Note C) ^a | 2,139,496 |
| Federal excess profits (Note C) ^a | 3,406,872 |
| Post-war credit..... | (351,082) |
| Other..... | 4,131,408 |
| Total operating expenses and taxes (before special charges below)..... | 37,564,061 |
| Net operating revenues (before special charges below)..... | 14,117,717 |
| Other income..... | (45,359) |
| Gross income (before special charges below)..... | 14,072,358 |
| Special charges equivalent to reduction in Federal excess profits taxes resulting from redemption of bonds (\$2,091,117) and sale of property (\$2,056,873) (reductions applied against related items charged to surplus)..... | 4,148,050 |
| Gross income (after special charges)..... | 9,924,308 |
| Deductions from income: | |
| Interest and amortization, etc..... | 3,719,527 |
| Net income..... | \$6,204,781 |

^a Federal income and excess profits taxes.

Note C to the income account as shown in the registration as originally filed and after Amendments 1 and 2 was changed by Amendment No. 3 by adding the following two paragraphs:

"Virginia Electric and Power Company—In addition to the reductions of Federal excess profits taxes payable for the year 1944 which resulted from costs and losses charged to surplus and for which special charges of equivalent amounts have been made in the income statement for that year, such taxes were further reduced \$537,496 by reason of the deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the company's

accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

"Virginia Public Service Company and Subsidiaries—Federal excess profits taxes payable for the period from January 1 through May 23, 1944, were reduced \$72,463 by reason of a deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the companies' accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities."

EXHIBIT D

Virginia Electric and Power Company and Subsidiary and Virginia Public Service Company and Subsidiaries, Combined—Condensed certified statement of income for 1944 as shown in amendment No. 4

| <i>Item</i> | <i>Amount</i> |
|---|---------------|
| Operating revenues..... | \$51,681,778 |
| Operating Expenses and Taxes: | |
| Other than taxes..... | 28,237,367 |
| Taxes: | |
| Federal income (Note C) ^a | 2,139,496 |
| Federal excess profits (Note C) ^a | 3,406,872 |
| Post-war credit..... | (351,082) |
| Other..... | 4,131,408 |
| Total operating expenses and taxes..... | 37,564,061 |
| Net operating revenues..... | 14,117,717 |
| Other income..... | (45,359) |
| Gross income..... | 14,072,358 |
| Deductions from income: | |
| Interest and amortization, etc..... | 3,719,527 |
| Special charges of those portions of premium and expenses on redemption of bonds (\$2,091,177) and of loss on sale of property (\$2,056,873) which are equivalent to resulting reduction in Federal excess profits taxes..... | 4,149,050 |
| Net income..... | 6,204,781 |

^a Federal income and excess profits taxes.

Note C to the income account as finally amended comprised six paragraphs. Three were identical with paragraphs 2, 3, and 4 of the original note. The other three read as follows:

"Virginia Electric and Power Company—Federal excess profits taxes payable for the year 1944 were reduced \$4,685,546 by reason of deductions for tax purposes of redemption premiums and expenses incurred in refunding of bonds, of a loss sustained on the sale of transportation property and of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. There have been included in the income statement for 1944 as special charges those portions of the refunding costs (\$2,091,177) and of the loss on sale of property (\$2,056,873) which are equivalent to the reductions in taxes resulting from these particular transactions, the remainder of such costs and loss being charged against earned surplus. No provision has been made in the company's accounts or income statement for the additional amortization allowable in respect of emergency facilities, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities.

"Virginia Public Service Company and subsidiaries—The statements of income for the year 1942 include provision for Federal normal income and excess profits taxes computed on the basis of taxable net income after deducting unamortized debt discount, call premium and expense on long-term debt called for redemption in 1942. The reduction resulting from the availability of these nonrecurring reductions in computing the amount of 1942 taxes payable amounts to \$1,571,153 and an equal amount has been deducted in the accompanying statements of income for 1942 as a special charge of debt discount, call premium and expense. The balance of unamortized debt discount, call premium and expense on long-term debt called for redemption in 1942 was charged against earned surplus.

"Federal excess profits taxes payable for the period from January 1 through May 25, 1944, were reduced \$72,453 by reason of a deduction for tax purposes of amounts, in excess of depreciation provided for at usual rates, allowable as amortization of emergency facilities under Section 124 of the Internal Revenue Code. No provision has been made in the companies' accounts or income statement for such additional amortization, since it is expected that the related facilities will be employed throughout their normal life and will not replace existing facilities."