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ABSTRACT

RAILROAD FINANCIAL REPORTING AND AUDITOR RESPONSIBILITY

by Phillip Andrew Jones, Sr.

The Uniform System of Accounts for Railroad Companies, prescribed by the Interstate Commerce Commission, differs in several respects from "generally accepted accounting principles." The two theoretically material variances relate to the use of flow-through accounting for federal income taxes instead of tax allocation and the use of betterment or replacement accounting for track components in lieu of depreciation accounting. The single factor that most often creates a material dollar variance between the two systems of financial reporting is the difference in the treatment of federal income taxes.

Certified public accountants attest to the fairness of presentation of published financial statements in accordance with generally accepted accounting principles. They invariably qualify their opinions on railroad annual reports because of the material dollar variance created by conformance with the Uniform System, thereby implying that the use of the Uniform System of Accounts as the basis of reporting does not yield fair presentation.

This thesis evaluated the Uniform System of Accounts in order to determine its relevance for published annual reports. The annual reports of thirty-seven Class I railroads comprised the sample which was analyzed. The questionnaire responses of twenty-four railroad companies and the opinions of financial analysts on railroad reporting were evaluated. Interviews with railroad industry personnel, certified public accountants, and members of the Interstate Commerce Commission were also relied upon. The currently employed concept of auditor responsibility was evaluated and conclusions were drawn as to the fairness of presentation achieved through the application of the Uniform System.

The results of the study indicate that both the Interstate Commerce Commission and the railroad companies questioned are essentially satisfied with the Uniform System. Fifty years of development have brought about a consistent set of accounting principles. Although this prescribed accounting is popularly known to be a "uniform system," alternate treatments for material items are allowed when properly justified to the Commission. The Commission's emphasis has evolved into one of fostering the national transport system. The Uniform System is as much for protection of the railroads as for control over them. The railroads are impressed by the progressive attitudes evidenced by the Commission in recent years and foresee a growing industry under continued regulation of this type.

The financial analysts contacted view the Uniform System as a relevant basis upon which to rest railroad financial reporting. They recognize flow-through accounting for federal income taxes and betterment accounting for track components as logical and appropriate solutions to difficult accounting problems.

If the Uniform System of Accounts provides an acceptable basis for financial reporting, the accounting profession should recognize it as such. Currently the profession appears to be stifled from exercising true professional judgment in its audit engagements through a self-imposed concept of "general acceptance." A more relevant concept of auditor responsibility would require the auditor to evaluate the results of the accounting principles applied by the company in order to determine their correspondence with the underlying economic flows. This concept of responsibility would certainly lend more professionalism to the profession. Improved financial reporting (more comparability) would result and railroads might no longer receive qualified audit opinions on their annual reports.

The majority of the railroads adhere to the Uniform System in their financial reporting while the accounting profession prefers conformity with generally accepted accounting principles. The profession stands at a crossroads; its action in this impasse situation may establish the pattern for the future. A weak stand, or no stand, on

the part of the profession could raise a question about the importance of the issues in dispute and perhaps of the opinion expressed by independent accountants on financial statements.

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AND AUDITOR RESPONSIBILITY

By

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A THESIS

Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of

DOCTOR OF PHILOSOPHY

Department of Accounting and Financial Administration

1968

G 53027

1/15/69

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ACKNOWLEDGMENTS

I wish to express my sincere appreciation to Dr. Herbert E. Miller for his wise counsel and able guidance, not only relating to the thesis but also to the development of my career goals. I also wish to offer my thanks to Dr. Roland F. Salmonson and Dr. John L. Hazard for their suggestions and guidance in developing this thesis.

The financial support provided by the Department of Accounting and Financial Administration during my tenure at Michigan State University is gratefully acknowledged.

Members of the Interstate Commerce Commission must be praised here for their cooperation and assistance. Mr. Richard Ferris showed tremendous patience with this researcher and demonstrated a sincere willingness to have the goals and actions of the Commission investigated. The certified public accounting firms of Arthur Andersen & Co., Haskins & Sells, Peat, Marwick, Mitchell & Co., and Price Waterhouse & Co. showed extreme willingness to cooperate and my sincere thanks goes to each of them.

My parents have shown me through time that the difficult is possible. My wife, June, and my children, Phillip and Valerie, have given me the reasons to attempt this difficult venture. All have helped where they could--parents through encouragement, June through typing all rough drafts of the thesis, and the children through sheer patience exercised throughout the ordeal. My thanks to them all.

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CHAPTER I

NATURE AND SCOPE OF THE PROJECT

Purpose of the Study

The purpose of this study was to evaluate the current state of annual financial reports to the public by railroad companies and the views of the accounting profession relative thereto as a guide to expected future reporting and auditor responsibility. The methodology, of necessity, was primarily deliberative and analytical, conducted by analysis of railroad annual reports, a surveying of railroads by means of a questionnaire, interviews and correspondence. The purpose for establishment, history of accomplishments and current effectiveness of the Uniform System of Accounts for Railroad Companies prescribed by the Interstate Commerce Commission were evaluated. "Generally accepted accounting principles" were considered, insofar as they differ from the principles underlying the Uniform System. It was necessary to evaluate the progress of the accounting profession toward improved financial reporting and the responses of the railroads and the Interstate Commerce Commission to this progress. A standard for auditor responsibility was developed against which to measure the accomplishments of the accounting profession.

Statement of the Problem

Financial reporting to the public in the railroad industry is in a state of flux. In 1962, a ruling by the Interstate Commerce Commission allowed the railroads, for the first time, the freedom to choose generally accepted accounting principles for financial reporting to outsiders. This election could be made if the railroad companies would indicate in footnotes the extent of differences between these financial statements and the statements submitted to the Interstate Commerce Commission from the books and records kept according to the prescribed uniform accounts. Most railroad reporting, however, still reflects the accounting methods associated with the Uniform System of Accounts prescribed by the Interstate Commerce Commission. Some railroads have made modifications in the reported figures in order to bring the financial statements more in line with generally accepted accounting principles. A few have so completely adjusted their reported figures to those principles that the independent auditor feels justified in rendering an unqualified opinion. It is apparent that the two reporting systems are not interchangeable as one large midwestern railroad changed back in 1966 from reporting according to generally accepted accounting principles to reporting according to the Uniform System because of the effect on reported net income.

The first reporting standard from "generally accepted auditing standards" requires that the independent auditor state whether the financial statements being audited are presented in accordance with generally accepted accounting principles.¹ The majority of auditor's reports accompanying railroad statements are qualified reports comparing the financial presentation to generally accepted accounting principles while the railroads themselves often make no pretense of following these principles. Two certified public accounting firms sometimes use a three paragraph certificate for railroad companies, the second paragraph of which may read as follows:

The company maintains its accounts in conformity with the Uniform System of Accounts for Railroad Companies prescribed by the Interstate Commerce Commission and the accompanying financial statements have been prepared in accordance therewith. As explained in Note x, the provisions of the Uniform System of Accounts vary in certain respects from generally accepted accounting principles.²

¹Committee on Auditing Procedure, Auditing Standards and Procedures, Statements on Auditing Procedure, No. 33 (New York: American Institute of Certified Public Accountants, 1963), p. 16.

²Generalized from the 1966 Annual Report of The Atlantic Coast Line Railroad Company, p. 18. Mr. Russell D. Tipton of Haskins & Sells, in a letter dated March 1, 1968, states that the three-paragraph audit opinion is preferred by his firm because the opinion "clearly indicates the basis on which the financial statements are prepared, and directs the reader to a note which indicates the respects in which such basis varies from generally accepted accounting principles."

The opinion paragraph of this certificate then relates the financial statements to generally accepted principles of accounting. These certified public accounting firms apparently feel that a detailed description of the reason for the qualified report is relevant information to present to stockholders.

The New York Stock Exchange has twice, since 1962, taken the position that railroads should report according to generally accepted accounting principles in order to improve comparability between railroad financial statements and statements from other industries. The apparent freedom granted by the Interstate Commerce Commission in 1962 has not solved the problem of lack of comparability for at least two reasons. The first is, of course, that the attainment of absolute comparability between any two firms is difficult to achieve. The second is that the 1962 decision provided options of reporting according to the Uniform System, generally accepted accounting principles, or some hybrid system and the railroads have used all three.

Nature of Research Conducted

The bulk of the research conducted in this study relates to attitudes and ideas. Contacts with certified public accounting firms probed such issues as "betterment" or "replacement" accounting acceptance, the nature of the qualified audit opinion, the accounting professions's obligation toward improvement of railroad financial reporting,

the reasons for railroad industry adherence to the Uniform System for financial reporting, and the current and potential usefulness of the Uniform System.

From the railroad industry, through communications, a questionnaire, and an interview, confirmation was received as to the reason for conformance to the Uniform System, the degree of industry satisfaction with the Uniform System, and guides to the future with regard to greater conformance with generally accepted accounting principles, either within or outside of the Uniform System.

The Interstate Commerce Commission is the primary user of the data collected through the use of the Uniform System. Its evaluation of the system's past, present and future usefulness was quite valuable as was its projection of future conformity with generally accepted accounting principles.

The Securities and Exchange Commission and the New York Stock Exchange currently accept railroad financial statements based either upon generally accepted accounting principles or upon the Uniform System. Both of these organizations have sanctions that could be enforced against corporations which report in a misleading manner. A guide to their present position and future policies was of value.

There is currently a bill pending in the House Ways and Means Committee (H.R. 12175) the stated purpose of which is: "to prevent Federal regulatory agencies from directly

or indirectly denying regulated industries the right to exercise business judgment in selecting their method of depreciation or to account for depreciation on a deferred tax accounting basis." The intent and sponsorship of this bill might indicate congressional response to groups dissatisfied with regulatory accounting practices.

Research Methodology

Library search was necessary to develop the framework for evaluations of the Uniform System of Accounts and generally accepted accounting principles. Other aspects of the project such as the history of the Arthur Andersen & Co. petitions and a criterion against which to evaluate auditor responsibility also required search of the literature.

The analyses of railroad financial statements and the auditor's reports were necessary for the establishment of current practice. A sample of Class I railroads selected by Moody's Investors Service, Inc. on the basis of the "relative importance and size of the various companies as well as upon the amount of investment interest" was used in this study³ (Appendix A). Based upon a report of the Association of American Railroads,⁴ this sample of thirty-nine Class I

³Letter, dated June 30, 1967, from Richard G. Neumeier, Consultation Department, Moody's Investors Service, Inc.

⁴Bureau of Railway Economics, Yearbook of Railroad Facts (1967 ed.; Washington, D.C.: Association of American Railroads, 1967).

railroads covered the majority of the industry (Appendix A). Class I railroads represent about 99 per cent of the railroad industry in terms of traffic, operate 94 per cent of rail mileage and account for 92 per cent of the workers employed by all railroad companies.⁵ A Class I railroad is defined as one which has annual operating revenues of \$5,000,000 or more.⁶ The financial statements and auditors' certificates were analyzed in order to identify similarities and differences in statement presentation among companies and in auditor's opinions.

The interview technique was applied in this study as follows. The issues were defined and a list of questions prepared before the interview. The notes taken during the interview were used to prepare a summary of the discussion. This summary was then sent to the party interviewed for his comments and criticisms so as to verify the perceptions received during the interview. The same basic questions were asked of several sources so as to be able to distill the issues and properly interpret the responses.

Communications with selected sources were used to supplement the interviews and to gain information from sources where an interview would not be practical. Less reliance can be placed on written communications, than on interviews, because of the inherent limitations in the

⁵Ibid., p. 2.

⁶Ibid.

technique. However, the differences in the kinds and importance of information acquired through the several techniques were such that both were justified in their use.

Limitations of the Study

There were at least three basic limitations to the study. The first was a limitation inherent in the subject matter investigated. There was very little that could be quantified and therefore very little that could be statistically evaluated. The material was judgmental and therefore necessitated interpretation. The second limitation related to methodology. The interview and communication techniques have numerous shortcomings which, hopefully, were mitigated by asking the same questions of several different sources and encouraging the sources to criticize the summary of the interviews. There was also a statistical limitation to the study. The sample of Class I railroads was not a random sample, therefore, it was not possible to generalize extensively. But, since the sample was selected on the basis of the relative importance and size of the companies as well as the amount of investor interest in the companies, generalizations relevant to the study could still be drawn.

Results of the Study

It is hoped that this study will contribute to a better understanding of railroad accounting, as an example of regulatory accounting. The reasons for "unusual"

practices were evaluated and these practices were compared with generally accepted accounting principles in an attempt to determine their validity for financial reporting purposes. From this analysis, a guide to better reporting standards for railroads may emerge.

Auditor responsibility, as usually conceived, is detailed in publications of the American Institute of Certified Public Accountants.⁷ These publications primarily stress clarifications and improvements of current practice but the concept of auditor responsibility they advance has been criticized both from within and outside the profession. A close look at these publications, an analysis of current practice, and a review of the literature on professional responsibility should result in the determination of guides to effective auditor responsibility.

⁷See for example: Committee on Auditing Procedure, Auditing Standards and Procedures.

CHAPTER II

THE UNIFORM SYSTEM OF ACCOUNTS
FOR RAILROAD COMPANIES

Introduction

The Uniform System was developed to serve primarily a regulatory function, to act as a matrix into which accounting information from all of the railroads could be placed such that valid inter-firm comparisons could be made and equitable economic regulation could be carried out. The system is quite detailed, especially as to classification of accounts. There is a chart of accounts and a comprehensive description of what should and should not be put into each of the accounts.¹ Also, there is a series of interpretations wherein the recommended accounting for special types of unusual transactions is presented.² These interpretations are based on circumstances referred by a railroad to the Interstate Commerce Commission for its consideration.

¹Uniform System of Accounts for Railroad Companies, prescribed by the Interstate Commerce Commission in accordance with Section 20 of the Interstate Commerce Act, issue of 1962, as amended to January 1, 1962 (Washington, D.C.: Government Printing Office, 1962).

²Interpretations of the Uniform System of Accounts for Railroad Companies, issue of 1962, effective September 1, 1962 (Washington, D.C.: Government Printing Office, 1962).

The system is therefore a guarantee of quite uniform reporting to the Commission. This chapter analyzes the reasons for creation, development over time, present justification and uniformity guaranteed by the Uniform System. Chapter III analyzes "generally accepted accounting principles," insofar as they differ from the principles underlying the Uniform System, in order to act as a standard for judging the prescribed accounting as a basis for financial reporting.

Reasons for Creation and Early History

During the nineteenth century, railroads existed in an unregulated environment. While this environment led to bold experimentation and a rapid expansion of the industry, it created, or accentuated, the numerous abuses which caused adverse public opinion and a marked change in public policy. The evils of highly speculative railroad building, of irresponsible financial manipulation, of destructive competitive warfare, of fluctuating and discriminating rate adjustments, of the overreaching exercise of monopoly power brought the inevitable reaction.³

Public response to railroad abuses was first manifested through state attempts to exercise control. In the United States, the earliest prescribed instructions for

³For a more detailed presentation, see: I. L. Sharfman, The Interstate Commerce Commission, Vol. 1 (New York: The Commonwealth Fund, 1931), p. 14.

keeping railroad accounts were issued in 1876 by the Railway Commissioners of Massachusetts.⁴ An outline for a uniform system of accounts for railroads was prepared by a special committee of State Railroad Commissioners and railroad accountants and adopted by all State Railroad Commissioners in 1879.⁵ It was also in the late 1870's, in the so-called Granger Cases, that the Supreme Court rejected the railroads' contention that they were private businesses not to be subjected to economic regulation.⁶ It definitely ruled that the railroads were "clothed with a public interest" and that the states therefore had the power to regulate them.⁷ State regulation turned out to be ineffective because so much of the railroad business was interstate rather than intrastate and different states set up different rules.⁸ The final blow to the possibility of effective state control came with a Supreme Court decision in 1886 where the Court decreed that "a statute of a State intended to regulate (transportation) from one State to another is not within the class of

⁴Eldon S. Hendriksen, Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 33.

⁵Ibid., pp. 33-34.

⁶Three cases are: *Munn v. Illinois*, 94 U.S. 113 (1877); *C.B. & Q. R.R. Co. v. Iowa*, 94 U.S. 155 (1877); and *Peik v. C. & N.W. Ry. Co.*, 94 U.S. 164 (1877).

⁷*Munn v. Illinois*, 94 U.S. 113 (1877).

⁸See for example: Kent T. Healy, The Economics of Transportation in America (New York: The Ronald Press Company, 1940), pp. 381-384.

legislation which the States may enact, (even) in the absence of legislation by Congress."⁹ This case pointed out that federal legislation was necessary for railroad regulation.

As a compromise to the Senate demand for an administrative commission and the House proposal for control through court-enforced vigorous laws, the Act to Regulate Commerce was passed in 1887. This act created the Interstate Commerce Commission and President Cleveland appointed five lawyers to comprise it.¹⁰ This was the first commission and it performed, and still performs, all three functions of government: administrative, legislative and judicial. Congress tends to view the commission form "as a creature of Congress, independent of the President, impartial and objective in the performance of its duties, and expert in the handling of complex, difficult matters beyond the capacity of Congress to handle effectively."¹¹ A creature of Congress, but legally oriented by its personnel, the Commission, as an investigating body, was authorized to

⁹Wabash Ry. Co. v. Illinois, 118 U.S. 557, 558 (1886).

¹⁰John R. Turney, Development of Internal Organization of the Interstate Commerce Commission (Washington, D.C.: Association of Interstate Commerce Commission Practitioners, 1963), p. 7.

¹¹Merle Fainsod, Lincoln Gordon, and Joseph C. Palamoun, Jr., Government and the American Economy (3rd ed.; New York: W. W. Norton and Company, Inc., 1959), p. 58.

inquire into the management of the business of all common carriers subject to the Act and to keep itself informed as to the manner and method in which the same is conducted.¹² For this purpose the Commission could require by subpoena the presence and testimony of witnesses and the production of books and papers; and it was also empowered to require annual reports from the carriers and to prescribe uniform accounts.¹³

The first classification of accounts issued by the Interstate Commerce Commission appeared in 1894.¹⁴ But, it was not until after the Hepburn Act of 1906 that the Commission was authorized to prescribe the form and substance of uniform accounts for railroads under its jurisdiction.¹⁵ Accordingly, a revised "Classification of Operating Expenses" was issued in 1907 and a complete "Accounting Classifications for Steam Railroads" became effective in 1914.¹⁶ The Hepburn Act of 1906 conferred upon the Commission the requisite authority for strict supervision of accounting and statistical

¹²Sharfman, p. 22.

¹³Ibid.

¹⁴Hendriksen, p. 34.

¹⁵The initial Commission appointed to its staff Henry Carter Adams, Professor of Economics and Finance at the University of Michigan, whose effort was outstanding in the development of the mandatory accounting, following the authority vested by the Hepburn Act.

¹⁶Hendriksen, p. 34.

practices. The availability to the regulatory tribunal of prompt, full and accurate financial and operating data, as a necessary basis for the effective enforcement of all the provisions of the Act, was considered to be of far-reaching importance. The Commission was enabled not only to prescribe uniform accounts and to require, under oath, standardized reports, both regular and special, but it was given the right of access to and examination of the accounts and records of the carriers, and heavy penalties, including imprisonment, were imposed for willful obstruction or falsification.¹⁷ The Supreme Court in 1913 affirmed the Commission's power to prescribe uniform accounting.¹⁸

Developments Affecting the Uniform System

Four key items stand out in the development of the Uniform System: The Valuation Act of 1913 and similar legislation, the controversy over the acceptability of depreciation accounting, the formation by the American Institute of Accountants of a Committee on Relations with the Interstate Commerce Commission and the immediate results, and the acceptance of reporting according to the Uniform System by

¹⁷Sharfman, p. 44.

¹⁸Kansas City So. Ry. v. United States, 231 U.S. 423, 442-3 (1913).

the New York Stock Exchange and the Securities and Exchange Commission.

The Valuation Act.--By 1913, public reaction to the "watering" of railroad stock had been worked up into enough of a political issue by Senator LaFollette to result in the passage of the Valuation Act.¹⁹ The Interstate Commerce Commission had also expressed conclusions in favor of valuation. The Valuation Act required the Interstate Commerce Commission to determine and report the value of all the property owned by every common carrier. The Commission, through Valuation Order No. 3, was required to thereafter keep itself informed of all extensions and improvements or other changes in the condition and value of the property of all common carriers, and determine the value thereof, and from time to time revise and correct its valuations.²⁰ The initial, and subsequent, valuations were to be on the bases of (1) original cost to date, (2) cost of reproduction new, (3) cost of reproduction less depreciation, and (4) other values and elements of value, if any.²¹ The initial valuation took about twenty years at a cost of about \$200 million.²² The result is probably the largest compilation of economic records ever made. One writer, at least, feels that these values have not been of any great help in the rate-making

¹⁹Healy, p. 393.

²⁰Turney, p. 21.

²¹Ibid., p. 18.

²²Healy, p. 540.

process and seriously doubts if they have been worth even a fraction of the expense involved.²³ However, original cost to date, as the result of valuations, presently serves as the basis of valuation for recorded railroad assets.

Depreciation accounting.--The early concern for a clear distinction between capital and revenue expenditures by the railroads caused considerable controversy over the recording of depreciation and other methods of providing for capital maintenance. Toward the end of the nineteenth century, the most commonly accepted method among railroad firms in the United States and England was the "replacement" or "renewal" method whereby all replacement expenditures were charged to expense at the date of replacement or renewal; the original cost of the asset was not depreciated.²⁴ The initial invested capital was assumed to be maintained permanently by regular expenditures for repairs and renewals. The property of a railroad company was considered so diverse that renewals were assumed to be made continuously and in amounts at least equal to what depreciation would have been if it had been accrued.²⁵ Depreciation was introduced in 1914 for equipment only and Congress authorized and directed the Interstate Commerce Commission to deal with the whole

²³Ibid., p. 541.

²⁴Hendriksen, p. 34.

²⁵Ibid.

question comprehensively in 1920.²⁶ Studies and hearings were conducted on the subject in 1924 and a decision was rendered in 1926. This issue was reconsidered in 1929 and a new and different decision emerged in 1931. The proposed regulation was suspended in 1932 because of the depression. This regulation would have ordered depreciation applied on a straight-line basis. The order, modified to some extent, was finally put into effect in 1943, but replacement accounting is still used for rails, ties, ballast and other track materials. The courts finally accepted an accounting definition of depreciation in 1934,²⁷ so the intentions of the Interstate Commerce Commission were more modern than the court system, even though the Supreme Court, in 1913, had called depreciation "an inevitable fact which no system of accounts can properly ignore."²⁸

American Institute Committee.--In a letter to Anthony F. Arpaia, Chairman of the Interstate Commerce

²⁶George O. May, "Improvement in Financial Accounting," Dickinson Lectures in Accounting (Cambridge, Massachusetts: Harvard University Press, 1943), p. 26.

²⁷Lindheimer v. Illinois Bell Telephone Company et al., 292 U.S. 154 (1934). Chief Justice Hughes: "Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence. Annual depreciation is the loss which takes place in a year."

²⁸Kansas City So. Ry. Company v. United States, 231 U.S. 423 (1913).

Commission, on May 17, 1956, Phillip L. West, Vice President of the New York Stock Exchange, suggested that the Uniform System should attempt to conform with generally accepted accounting principles. He suggested as a means of accomplishing this purpose that the American Institute of Accountants establish a committee to study these differences and recommend solutions. The Chairman of the Commission agreed and a committee was appointed by the president of the Institute on or about June 5, 1956. This committee (Committee on Relations with the Interstate Commerce Commission), on March 29, 1957, made a report to Owen Clark, then Chairman of the Commission, in which six principles of the Uniform System were found to be at variance with generally accepted accounting principles. These were:

1. The retained income account (formerly called profit and loss account) of the railroads relieves current income of items which under generally accepted accounting principles would be included as charges or credits in current income.
2. Appropriations are made by railroads under the category of "disposition of current income" for items such as sinking funds and other capital requirements which under generally accepted accounting principles are not of an expense nature and would not be chargeable to income.
3. Income taxes are dealt with on the basis of charging railway operating expenses for essentially all accruals and adjustments of income tax, whereas other industries allocate a portion of such taxes to other accounts and/or to other years when there are divergencies between the handling of major items of income or expense for tax purposes and for financial accounting purposes.

4. The acquisition adjustment account of the railroads comprises a variety of diverse elements. Under generally accepted principles of accounting, identification and segregation of the respective elements would be required and, as to certain elements, the establishment of a policy for ultimate disposition might be appropriate.
5. The railroads do not deal with long-term debt maturing in one year and certain other liabilities as current liabilities.
6. Voucher drafts outstanding are shown as liabilities rather than reductions of cash.²⁹

The Committee also considered the issue of replacement or betterment accounting as applied to track components and concluded that "no substantial useful purpose would be served by a change to depreciation accounting techniques in the absence of evidence indicating that depreciation-maintenance procedures would provide more appropriate charges to income for the use of such property."³⁰

During the years 1957-58, the Interstate Commerce Commission conducted a complete study and review of its accounting rules in order that prescribed procedures might be more in line with the best present-day practices. Considerable impetus was given to this work by the report of

²⁹Letter reproduced in: Arthur Andersen & Co., Cases in Public Accounting Practice, Vol. 7: Interstate Commerce Commission Jurisdiction Over Financial Statements in Reports to Stockholders (Chicago: Arthur Andersen & Co., 1962), pp. 22-23.

³⁰Ibid., p. 24. There was one dissent to this report, that of Arthur J. Abbott of Arthur Andersen & Co., who took exception to replacement accounting acceptance by the Committee.

the Committee. Most of the modifications suggested by the Committee were put into effect by the Commission effective January 1, 1958. Major changes in the railroad rules which were adopted were to:

1. Require that all gains and losses recognized during the year are to be included in net income, except special and extraordinary items, material in amount, which are not identifiable with usual or typical business operations and would impair the significance of net income for the year and be misleading unless such items are excluded.
2. Require that there be excluded from net income the federal income tax consequence of special and extraordinary gains or losses in situations where such gains or losses are excluded from net income in financial statements.
3. Provide a separate balance sheet account to show the important item of liability for federal income taxes, apart from the other taxes.
4. Provide a separate balance sheet account for equipment trust notes and installments on debt obligations, regularly employed by railroads for financing acquisition of equipment and facilities, which are to be paid within one year.
5. Provide that estimated amounts payable within one year covering liability on claims for injuries to persons, loss and damage to shipments in transit, and other casualty losses shall be classified in the balance sheet under current liabilities.
6. Provide that cash balance shown in financial statements shall reflect reductions because of bank checks and drafts, issued by the fiscal officers and agents of the company in payment of obligations and released to payees but not yet paid by banks.³¹

³¹As reported by Herschel C. Walling, "Changes in Railroad Accounting Rules," The Federal Accountant, June 1958, pp. 55-56.

It is important to note, however, that the Commission's position on the area of deferred federal income tax accounting was not modified. The Uniform System still does not have this provision. The Commission also made a distinction between material and nonmaterial extraordinary items in terms of the accounting treatment to be accorded. No change was made regarding the use of replacement accounting for track components. These three areas--accounting for federal income taxes, extraordinary items, and betterment accounting--remained as the only significant variances from generally accepted accounting principles.

Acceptance for reporting.--The Securities Act of 1933 provides that the financial statements required to be made available to the public through filing with the Securities and Exchange Commission shall be certified by an independent public or certified accountant.³² But, the Act exempts from its provisions carrier securities whose issuance is subject to regulation by the Interstate Commerce Commission.³³ Therefore, annual railroad financial reports

³²As reported by: J. Arnold Pines, "The Securities and Exchange Commission and Accounting Principles," Law and Contemporary Problems: Uniformity in Financial Accounting, XXX, No. 4, School of Law, Duke University (Autumn, 1965), 728.

³³J. H. Price, Jr., Richard Walker, and Leonard Spacek, "Accounting Uniformity in the Regulated Industries," Law and Contemporary Problems: Uniformity in Financial Accounting, XXX, No. 4, School of Law, Duke University (Autumn, 1965), 827.

to stockholders are not required to be audited. In a sample of 37 annual reports, the following was found: 31 were audited and 6 were unaudited (2 of these 6 had received auditor certificates for consolidated subsidiaries). That is, 16.2 per cent of the sample was not audited--a percentage that would not be descriptive of other industries.

The Securities and Exchange Commission took a position in Accounting Series Release No. 4 (1938) that financial statements prepared in accordance with accounting principles for which there is "substantial authoritative support" would not be presumed to be misleading or inaccurate. Although the Commission has not elaborated on the meaning of "substantial authoritative support," at least the following should qualify: pronouncements of the American Institute of Certified Public Accountants; American Accounting Association pronouncements; uniform systems of accounts, regulations and rulings of federal and state regulatory authorities; and uniform systems of accounts recommended by certain trade associations for members of an industry.³⁴ For registration under the Securities Exchange Act of 1934 and in lieu of annual submission of 10-K annual reports, the Commission will accept copies of the reports filed with the regulatory agency in certain industries, including the

³⁴Louis H. Rappaport, SEC Accounting Practice and Procedure (2nd ed.; New York: The Ronald Press Company, 1963), pp. II-7.

railroad industry.³⁵ The major reason for "acceptance" by the Commission of the Uniform System for railroad accounting is a provision of the Securities Act of 1933 which prohibits the Commission from prescribing accounting requirements inconsistent with those prescribed by the Interstate Commerce Commission.³⁶

The New York Stock Exchange also makes an exception for railroads, on the original listing application. Except for railroad companies, corporate statements must be audited by certified public accountants.³⁷ The New York Stock Exchange, then, essentially accepts what the Securities and Exchange Commission accepts. It is interesting to note that both of these agencies have sanctions that can be used against companies which are considered to be reporting inaccurately or in a misleading manner. Therefore, these agencies must consider reporting according to the Uniform System to be neither inaccurate nor misleading, even though the System does not conform to generally accepted accounting principles.

³⁵ Ibid., pp. XII-3, and XII-6.

³⁶ Letter dated December 12, 1967, from Lindsey J. Millard, Associate Chief Accountant, Securities and Exchange Commission.

³⁷ George L. Leffler (dec.), The Stock Market, revised by Loring C. Farwell (3rd ed.; New York: The Ronald Press Company, 1963), p. 132.

Present Justification³⁸

The Interstate Commerce Commission (the first and oldest independent federal agency) has regulatory jurisdiction over four different modes with eleven different kinds of carriers. It regulates all aspects of the transportation business including the accounting and financial reporting functions of the subject carriers. One of the underlying purposes of the Commission's regulatory activities concerns the maintenance of an efficient national transportation system adequate to meet the ever expanding needs of the nation's commerce, the national defense and the postal service. Changing circumstances and economic conditions, therefore, affect the Commission's pattern of regulation.

From the creation of the Commission in 1887 up until the middle 1930's, its regulation for the most part was confined to the railroad industry. During that period, it might appear that the Commission gradually became more static in its policies and approach to regulation. This may be evidenced by the Commission's tendency to hold on to traditional techniques and procedures whose applicability and usefulness might be questioned because of changes in the economic climate and other factors. Regardless of the merits of that contention, the Commission has kept abreast

³⁸This section is adapted from an interview with Richard J. Ferris, Assistant Director, Bureau of Accounts, Interstate Commerce Commission, January 29, 1968.

with the thinking and developments in the unregulated industrial and commercial sectors and has been quick to incorporate in its accounting regulations those new concepts and standards deemed to further the attainment of regulatory objectives. At the time the motor carrier industry was placed under regulation in 1935, the Commission undertook a particularly comprehensive and penetrating evaluation of its accounting regulations to determine where improvements could be made to assure that the prescribed system would produce financial information that fully met the needs and purposes of carrier management and also provided the current knowledge required for effective and meaningful regulation. It is an interesting sidelight that when they first came under regulation in 1935, several of the largest motor carriers already had modern accounting systems which had been developed under the supervision of outside CPA firms. It can be surmized that this situation had a substantial influence on the Commission's 1935 evaluation study. In any event, the initially prescribed accounting regulations were based on the most progressive and advanced concepts with the result that conversion over to the Commission's new system was accomplished by the major motor carrier companies with a minimum of difficulty.

The railroad industry uses highly progressive accounting techniques because it has perhaps the largest and most complex accounting task of any of the nation's major

business enterprises. As one example of the immensity of its problems, shipments of freight (carload, less-carload, container, or piggyback) are transported in freight cars from coast to coast over the connected tracks of as many as ten or more different railroads. This generates numerous accounting transactions among the railroads participating in the transportation; transportation and accessorial revenues must be divided, and various related costs allocated such as shipment loss and damage, equipment rental and repairs enroute, trackage allowances, switching services, etc. To aid in handling their gigantic accounting task, the railroads were the largest users of punched card equipment before the growth in popularity of such equipment. They also were among the first to recognize the possibilities of the computer and the great majority of railroads are now highly computerized. In recent years many roads have hired CPAs to fill financial executive positions. This brings qualified professionals into an important sector of management responsibility. It also has helped to correct misunderstandings and in mitigating the criticism that CPAs have long voiced about railroad accounting.

Financial reporting.--Financial information accumulated under the Uniform System of Accounts for Railroad Companies serves as a standard by which the results of operations for the individual railroads can be compared and evaluated on a common basis. The surest way to destroy

uniformity is to allow alternative methods of accounting for the same transaction or event, as does "generally accepted accounting principles." This statement is not intended to imply that absolute uniformity is guaranteed by the Uniform System. A carrier may, upon submission of a request, be granted a deviation from the Uniform System if the Commission feels that such a deviation more properly presents the financial results of the firm involved and has no negative influence on the remainder of the transportation system.

The use of the Uniform System for rate-making purposes is premised on the proposition that the Commission should be primarily concerned with today and the problems of today. The concern should be for rates that are equitable for the shipper of today and railroad accounting is structured to this end. However, this emphasis on rate-making should not be taken as the only responsibility of the Commission. Forty years ago, rate-making was the predominate responsibility; however, managerial and investor responsibilities are perhaps of equal if not greater importance today. Because of the competition in the transportation industry and the statutory restrictions placed upon the ICC that no mode of transportation should be deprived of its inherent advantage, the ICC must have broad concepts. Section 20(a) of the Interstate Commerce Act repeatedly uses the phrase "compatible with the public interest" in describing the accounting responsibilities of the Commission.

Under the concept that "public" includes shippers, other modes of transportation, individual carriers, stockholders, bond holders, etc., it is apparent that the Commission has broad responsibility relative to railroad accounting systems and financial reporting.

As an example of this responsibility toward the accounting and reporting of railroads, the ICC considered the deferred tax issue in 1958 and released its report in February of 1959 (included as an appendix to Docket No. 34178 decided February 1, 1963). The railroads and Commission felt that the use of tax allocation would have two negative effects. The tax expense reported under this method would reduce net income and could possibly bring about demands for rate adjustments which would benefit future shippers to the detriment of present shippers. Also, the highly speculative nature of the deferred taxes payable account made it difficult to conceive of reporting such a nebulous liability. Accelerated depreciation and tax allocation were accepted into generally accepted accounting principles in 1958. In the ten years of experience recorded so far, railroads have not had to pay any taxes as the result of loss of tax benefits. The Commission, therefore, can justify its 1959 action in that the tax benefits of accelerated depreciation, guideline lives, and the investment credit have tended to increase and so, in the aggregate

sense, have been permanent tax savings not deferrals of benefits.

Should economic circumstances change, this decision would most likely be reviewed. If the railroad industry should, in the future, present a united front in favor of tax allocation, the ICC would reconsider the issue. It appears, though, that if the railroads continue to replace their equipment at the present rate, there won't be a tax reversal in the aggregate sense. The Commission presently is requiring the railroads to provide information on the excess depreciation claimed for tax purposes. It is believed that with such information the ICC will be in a better position to determine whether or not the deferred tax issue will need to be reconsidered. In any reconsideration of tax allocation, the increased probability of higher future tax payments would need to be weighed against the probable effects on rates. At present a procedure is open to the railroads should they foresee an eventuality of paying these higher taxes. An appropriation of surplus can be made for this purpose and it serves two functions: it indicates the projected eventuality in the accounts while at the same time it indicates the contingent nature of the liability. The railroad cannot create a balance sheet liability for this purpose nor can it charge these questionable taxes to income. The rationale is something like this.

The tax law does not imply that anything done in 1958 has any effect on 1968. The railroads were not required to adopt accelerated depreciation for tax purposes. If they did adopt it, they adopted it knowing the risk of possible future tax reversal.

The ICC rule-making procedure is initiated by changes in economic circumstances. The Commission studies the matter carefully and elicits the response of experts in the industries to be affected. A Proposed Rule Making is prepared and distributed to the regulated industries, CPA firms, shippers, and other interested parties for their responses. The responses are carefully evaluated and a final Decision and Order are released by the Commission. The process is therefore not doctrinal in nature, rather it is responsive to the wishes of the affected parties, subject to the restriction that the best interests of the national transport system must be maintained.

The Commission does not oppose CPA audits on regulated industries, however, it feels that the CPA examination is not a substitute for the audit performed by the ICC auditors. The CPA audit is concerned with the fairness of presentation of the financial results while the ICC audit is more specialized. The ICC feels that the Uniform System "fairly presents" the financial results for a firm but the transactional analysis and the statistics created from the system are also parts of the ICC audit. The Commission currently has about sixty field auditors, highly trained specialists in railroad accounting. The training program

takes over a year and, even then, a new man is assigned to assist only. The schedule for Class I railroads calls for an annual Commission audit. The Commission accepts the independent audit as added assurance as to the quality of the accounting employed by a firm, but, because of the differing emphasis, feels that its audit must be retained. The Commission's audit staff is at least as independent as a certified public accountant's audit staff in its examination as the Commission's staff is concerned primarily with the information necessary to report and regulate the national transportation system and only secondarily with the individual company.

Relative to the establishment of depreciation rates, the ICC requests that railroads complete certain forms listing the assets owned, their service life, salvage value, and actual cost. The company develops depreciation lives and submits them to the Commission, based primarily on mortality tables reflecting the company's experience with these assets. It also submits its anticipated retirement date for the current inventory taking into consideration such factors as inadequacy, changes in the art of railroading, and more usage of equipment due to greater availability. The Commission has the power to make detailed analyses of the depreciation rate construction and may modify the company's proposed depreciation rates if they differ significantly from those used by other similar carriers. It also has the power to

question rates after establishment and ask for the company to submit justification data. Class I railroads are on a five year cycle of review regarding these rates.

The current uncertainty regarding obsolescence that has entered the picture as a result of the development of highly specialized cars complicates the rate setting procedure somewhat. The new aluminum covered hopper cars that cost about \$20,000 each are a case in point. In order to evaluate railroad depreciation rates, since there was no mortality experience, the ICC requested statements from the car manufacturers as to the life expectancy of the cars. The actual railroad experience with rolling stock (freight train cars) is a life expectancy of 28-30 years and the suppliers indicated that the same life could be expected for the new aluminum cars. The procedure then, for new or old equipment, is basically that the ICC prescribes depreciation rates but these rates are based upon data submitted by the company involved, tempered by judgment. Depreciation rates may vary, within limits, between companies because of management intentions relative to replacement and differing circumstances related to usage. To illustrate, large Class I railroads have between \$150 million and \$1 billion invested in rolling stock representing the cost of fleets of from 15,000 to 200,000 freight cars. It would be difficult to shorten the replacement interval significantly as a very high percentage of rolling stock is financed at original

purchase date, the obligation extending on the average about fifteen years. By the next five year cycle, the progressive roads may have reduced the average life of rolling stock to about twenty-five years.

Rate-making.--The Federal Power Commission has developed guideline rates of return for use as a yardstick to gauge the fairness of the rates charged by the respective companies engaged in the production and marketing of electric power and natural gas. This procedure is appropriate and practical for regulated industries which are monopolies and where the forces of competition play little if any part in the pricing of the products or services furnished. This same situation applied to a large extent in the earlier period of ICC regulation when the railroads enjoyed a virtual monopoly over public transportation. But the later growth and expansion of motor and water transportation has brought about radical changes in the transportation picture. Now railroads, motor carriers, air transport, pipe lines, and water carriers compete aggressively against one another for the available traffic.

Depending upon conditions and circumstances the ICC may apply different levels of cost in judging the reasonableness of contested rail rate proposals. In one case it may apply short-term out-of-pocket cost, in another, long-term out-of-pocket cost, and in a third, the fully distributed cost. Both long-term out-of-pocket and the fully

distributed cost levels include an allowance for return which is intended as the source of funds for interest and dividend payments and for replacement of equipment and facilities at a price level different from their original acquisition cost. The allowance is computed at a rate of 4 per cent (after taxes) on the depreciated book value of railroad property, plus a computed amount for working capital. The 4 per cent return rate (equal to about 6-1/2 per cent before Federal income tax) was originally selected on the basis of the historical earnings of the railroads over an extended span of time. Taken as a group, railroads have not succeeded in earning a 4 per cent return for a number of years. Partially, at least, this is due to the sharp competition offered by motor carriers and water lines.

In so-called general increase cases, i.e., where railroads as a group apply for an increase in their freight rates and charges (usually an across-the-board percentage increase), the Commission's decisions include some discussion on rates of return. However, the ultimate revenue level is generally determined on the basis of the total revenue needs, requiring a consideration of the necessary funds to cover interest payments and dividends for maintaining credit, and funds for capital expenditures in order to maintain an efficient national transport system. In this connection any serious study of the effect of flow-through accounting must weigh and consider the part that the forces

of competition have played in the railroad industry's comparatively low level of earnings in recent years. In marked contrast to the upward trend of prices for almost every product and service, railroad transportation rates have been on a descending scale for the past several years. This decrease in rates can be attributed primarily to competition from other transportation modes. Although the decision to retain flow-through accounting for federal income taxes was made on the basis of the speculative nature of the future tax expense, a positive side-affect can be seen in railroad financial reporting. Certainly the financial reports of railroads would have reflected a much more dismal picture except for flow-through accounting. Clearly their earnings and financial status, as shown in their published financial statements, have a profound bearing on the ability of the railroads to obtain vitally needed capital.

Degree of Uniformity Guaranteed

The control of railroads is about as complete as can possibly be imposed on any private enterprise. The Commission's control over literally every phase of rail transport is such as to endow it with a large measure of managerial powers. The fact that its control over the other agencies is much less complete is because of the technological conditions. Had it not been for these, it is reasonable to assume that all regulation of transport would have been as extensive as that of the railroads.³⁹

³⁹Dudley F. Pegrum, Public Regulation of Business (Homewood, Illinois: Richard D. Irwin, Inc., 1959), p. 566.

The Commission may inquire into the management of the business of all common carriers subject to the provisions of the act, and may prescribe the accounts, records, and memoranda which shall be kept by the carriers, which shall be open to examination by the Commission through its authorized agents or examiners. Carriers are required to file annual reports with the Commission and such other reports as the Commission may from time to time require. By the amendments of February 28, 1920 and September 18, 1940, the Commission was directed to prescribe . . . the classes of property for which depreciation charges may be included in operating expenses and the percentages of depreciation chargeable for each such class of property, with authority to modify such classes and percentages so prescribed when deemed necessary.⁴⁰

As the above quotations indicate, the Interstate Commerce Commission exercises a tremendous amount of control over the railroads and, to a lesser extent, over other carriers. The Uniform System of Accounts for Railroad Companies, as previously described, is the mechanism of control over the accounting aspect of the railroads. It guarantees uniform treatment of items and uniform reporting to the extent possible. There, however, cannot be absolute uniformity in reporting among companies because the system allows for alternative treatment in some cases. This lack of absolute uniformity was recognized twenty-five years ago.⁴¹ George O. May stated that "there is today a closer approach to

⁴⁰Moody's Investors Service, Inc., Moody's Transportation Manual (New York: Moody's Investors Service, Inc., September 1966), p. a68.

⁴¹George O. May, "Improvement in Financial Accounting," p. 31.

uniformity in the published accounts of the large steel companies than in those of the large railroads, though the former are not and the latter are subject to a uniform classification."⁴² Of course, May was making these observations before the recent updating attempts on the part of the Commission, attempts designed to conform the Uniform System more closely to generally accepted accounting principles.

To take a more meaningful look at uniformity in financial presentation, the present Uniform System must be evaluated. The present system is not too flexible as to the recording options available to a railroad. Depreciation rates and lives are established individually for each railroad as the result of a study by the Interstate Commerce Commission. This allows for some difference in reporting among railroads but a railroad must be able to justify the rates or lives it prefers or they will not be approved by the Commission.⁴³ Fairly definite lines are drawn between capital and expense items. For example, expenditures of a repair or replacement nature on a diesel engine valued at 50 per cent or less of the replacement cost of the diesel are considered expense; expenditures on the diesel exceeding 50 per cent of the replacement cost are considered capital

⁴²Ibid., p. 21.

⁴³From an interview, October 24, 1967, with Ernest J. Rua, Jr., of Peat, Marwick, Mitchell & Co.

in nature.⁴⁴ (Although this guide is purely arbitrary, it appears intuitively preferable to having no monetary guide at all.) Railroads have had an option in the treatment of profit arising from a repurchase of their own bonds, whether to treat this gain as income or an adjustment to retained earnings. The concept of materiality enters the picture here as in the case of property retirements. Retirements could be accumulated and the total considered a surplus charge while recurring retirements could be passed through income.⁴⁵ There are certain amendments to the Uniform System of Accounts for Railroad Companies which have recently been released by the Interstate Commerce Commission.⁴⁶ "Although the . . . amendments improve current regulations which conditionally permit direct charges to retained earnings they do not conform completely with Accounting Principles Board Opinion 9 on reporting the results of operations."⁴⁷ The changes: "(a) generally require that items affecting net income be recorded in appropriate profit and loss accounts, and (b) explain, define and provide accounts and categories

⁴⁴ Ibid.

⁴⁵ From an interview, October 23, 1967, with Delbert Wacker of Arthur Andersen & Co.

⁴⁶ Interstate Commerce Commission, Uniform System of Accounts for Railroad Companies, Docket No. 32153, Service Date September 12, 1967.

⁴⁷ From the minutes of the July 19-20, 1967 meeting of the Executive Committee of the American Institute of Certified Public Accountants.

for ordinary income, extraordinary items, prior period items and applicable income taxes."⁴⁸ The surplus charge option will no longer be available; all elements of revenue, expense, profit or loss will be put through the income statement. A divergence from generally accepted accounting principles, as stated in Accounting Principles Board Opinion No. 9,⁴⁹ will be created in that prior period items will be charged or credited to income rather than allowed to remain as an adjustment to retained earnings.

Summary

The Uniform System of Accounts for Railroad Companies was developed to serve the early twentieth century need for control over the financial and rate practices of the railroads. It was a well constituted system of accounts and has apparently served its regulatory ends in a satisfactory fashion. The New York Stock Exchange and the Securities and Exchange Commission accept financial statements prepared on this basis in lieu of audited statements prepared in accordance with generally accepted accounting principles. The public accounting profession, through the

⁴⁸ Editorial, The Journal of Accountancy, July 1967, p. 3.

⁴⁹ Accounting Principles Board, Reporting the Results of Operations, Opinion No. 9 (New York: American Institute of Certified Public Accountants, December 1966), pp. 115-116.

Committee on Relations with the Interstate Commerce Commission, has assisted in bringing about substantial changes in the Uniform System during the past decade, however, significant variations still exist.

CHAPTER III

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND THE UNIFORM SYSTEM

Introduction

Generally accepted accounting principles are man-made statements about what "should be" in accounting. They are generally accepted because of practicality as well as justifiability. General acceptance may mean imposition by a higher authority, as in the case of the uniform systems of accounts prescribed by regulatory agencies.¹ However, realistic guides to action for the accounting profession must be justified by logic, not by practice or authority alone. The principles referred to by members of the American Institute of Certified Public Accountants in their audit certificates have been developed over time in the search for better financial reporting. These principles were developed as a means to the end of fair presentation of financial position and the results of operations to which

¹Paul Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises, Accounting Research Study No. 7 (New York: American Institute of Certified Public Accountants, 1965), pp. 52-53.

the auditor attests. Therefore, generally accepted accounting principles will be utilized as a standard against which to measure any divergence from fair presentation of the Uniform System basis of reporting. The generally accepted accounting principles which are not a part of the Uniform System will be detailed, evaluated, and contrasted with the alternative principles in the Uniform System. The opinions expressed by three financial analysts and thirty-one audited railroad companies will also be analyzed. Conclusions will be drawn as to the relative acceptability of each system in the areas of accounting for federal income taxes and capital asset accounting for track components.

Value of Accounting Principles

The payment of federal and state income taxes, ad valorem and franchise taxes and taxes to local bodies, the revenue receipts of these governmental bodies, the payment of dividends, the buying and selling of securities, stockholder's reports, information for management, regulatory purposes--are some of the areas in which accounting has vital impact. . . .

The consequences that flow from adherence to any system of accounting have far-reaching effect. This is especially so in the case of regulated industries such as the railroads.²

The primary focus of this paper being financial reporting, it can be seen that accounting principles of some sort are important. The reason for their importance is as follows.

²"Railroad Accounting Procedures," A Report by the Committee on Government Operations, condensed in The Journal of Accountancy, November 1957, p. 70.

Accounting principles may be defined as guides to action, second-level propositions derived from general postulates describing the function of the discipline. In 1953, the Committee on Terminology of the American Institute of Certified Public Accountants selected as its definition of an accounting principle: "a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice. . . ." ³ The essential members of a structure of accounting theory were presented to the Institute by another Committee in 1958. This Committee (Special Committee on Research Program) defined postulates, principles and rules and their interrelationships in the framework of accounting theory.

Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. . . . A fairly broad set of co-ordinated accounting principles should be formulated on the basis of the postulates. . . . Rules or other guides for the application of accounting principles in specific situations, then, should be developed in relation to the postulates and principles previously expressed. ⁴

Based upon a determination of the objectives of accounting, postulates may be developed which serve the additional

³Committee on Terminology, Review and Resume, Accounting Terminology Bulletins, No. 1 (New York: American Institute of Certified Public Accountants, 1953), p. 11.

⁴"Report to Council of the Special Committee on Research Program," The Journal of Accountancy, December 1958, p. 63.

function of setting forth the boundaries of the field of study.⁵ From these postulates, principles or second-level generalizations can be drawn.⁶ The actual rules or practices can then be developed to carry out the principles. The principles, then, are the logical basis for action and the rules are the operational devices needed to put the principles into practice. Alternative practices may be developed to discharge one particular principle but even though the practices lead to different answers, the alternatives are still correct. This is a basic statement of the position held toward theory by the American Institute of Certified Public Accountants.

Generally Accepted Accounting Principles v. The Uniform System

Without a doubt the American Institute of Certified Public Accountants has been the most influential society in the United States in the development of generally accepted accounting principles. These principles and standards are found primarily in the Accounting Research Bulletins issued by the Committee on Accounting Procedure, the Opinions of

⁵See: Maurice Moonitz, The Basic Postulates of Accounting, Accounting Research Study No. 1 (New York: American Institute of Certified Public Accountants, 1961).

⁶See: Robert T. Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises, Accounting Research Study No. 3 (New York: American Institute of Certified Public Accountants, 1962).

the Accounting Principles Board and the Research Studies of the Accounting Research Division. However, prior to 1930, little was done to develop a formal structure for the development of accounting principles and theory.⁷

The test of rules and practices, as currently evidenced by auditors' certificates, is the conformity of these rules and practices to generally accepted accounting principles. The independent auditor attests to fairness of presentation based upon the consistent application of these principles. This set of principles could be called a "uniform system" except that the diversity of rules implementing them leads to less than uniformity in financial reporting. Grady states that, in theory, management is therefore charged to choose the accounting practices and methods of application most suitable to the needs and purposes of the entity and which, in its judgment, will most fairly present the financial position and results of operations of the entity.⁸

In nonregulated industries, the choice of accounting practices belongs to management; in regulated industries the accounting rules are primarily prescribed by the regulatory agency. The responsibility for financial reporting practices,

⁷Eldon S. Hendriksen, Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 79.

⁸Grady, p. 34.

then, resides with the agency. Financial reports are necessary for effective regulation of an industry.

What action could be taken to assure that the financial, statistical and other information reported to the [Interstate Commerce] Commission not only was accurate, but that of equal importance, it was similar in substance and nature for all railroads? Similarity in the reported information was of utmost necessity; otherwise the operations of railroads could not be compared either individually or by groups, nor could the Commission readily determine the current state and condition of the railroad industry.⁹

After considerable study it was decided that the objective of comparable reporting could best be obtained under a system of uniform accounting which would assure that all railroads used the same methods and procedures. The primary objective of the Uniform System is, of necessity, uniformity for regulatory purposes. Fairness of presentation in financial reporting was considered but this goal is not necessarily compatible with uniformity for regulation.

Accounting for Federal Income Taxes

It is generally recognized that the net income reported in annual financial statements may differ from the net income subject to federal income taxation. These

⁹Richard J. Ferris, Assistant Director, Bureau of Accounts, Interstate Commerce Commission, "The Uniform System of Accounts: Development and Performance," a speech before the Seventy-first Annual Meeting, Accounting Division, Association of American Railroads, May 31, 1966, p. 6.

variances may be caused by timing differences in the deductibility of certain items between tax return and book. Examples are accelerated depreciation and guide-line lives for taxation purposes but straight-line depreciation and longer use-lives for book purposes. The Uniform System and generally accepted accounting principles differ as to their treatment of the tax effects of these timing differences. The Interstate Commerce Commission prescribes "flow-through" accounting for such tax effects and the investment credit, that is, no deferral of the tax effect of the timing difference between the tax on taxable income and the tax on pre-tax accounting income. The charge to income is thereby restricted in the current year to the amount of federal income tax indicated to be payable on the tax return. Generally accepted accounting principles prefer deferring this difference resulting from timing because it is believed to be only a temporary tax saving. Tax deferrals are viewed as "privileges established by law, and if, instead of the deferral of the tax, the tax is to be eliminated, this can only be done by changing the law."¹⁰ Tax allocation is viewed as a generally accepted accounting principle and a qualified opinion is given by the independent auditors to firms not following this practice. Of 31 railroad financial

¹⁰Leonard Spacek, "A Report by a Critic of His Profession," a speech presented at the Sixth Annual Accounting Forum of Hayden, Stone, Incorporated, November 10, 1967, p. 23.

statements in the sample that were audited by certified public accountants, 4 were unqualified while 27 received qualified reports, 23 of the 27 being qualified for lack of tax allocation.

Position of Accounting Principles Board.--The Accounting Principles Board sets forth three approaches to tax allocation.¹¹ The "deferred method" is a procedure whereby the tax effects of current timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse. The "liability method" proceeds in the same manner with the exception that the initial computations are considered to be tentative and are subject to future adjustments if tax rates change or new taxes are imposed. The "net of tax method" considers the amount computed under either of the preceeding approaches as a contra-asset (or contra-liability) account on the basis that tax deductibility or taxability are factors in asset and liability valuation. The Board concluded that the "deferred method" is most appropriate because it treats income tax expense as a consistent and integral part of the process of matching revenues and expenses in the determination of results of operations. This method "emphasizes the

¹¹Accounting Principles Board, Accounting for Income Taxes, Opinion No. 11 (New York: American Institute of Certified Public Accountants, December 1967), pp. 162-163.

tax effects of timing differences on income of the period in which the differences originate."¹²

The Board then recognized and commented upon three differing views as to the extent to which interperiod tax allocation should be applied in practice.¹³ A minority opinion is that tax allocation is never appropriate. This view is based upon a concept of federal income taxes as an imposed expense, determined by appropriate laws and regulations of the governmental unit, which requires no adjustment or allocation. The "partial allocation" approach suggests that recurring differences between taxable income and pretax accounting income, which give rise to an indefinite postponement of tax payments, do not require allocation. Proponents of this approach point out that the application of tax allocation procedures to tax payments or recoveries which are postponed indefinitely involves contingencies which are at best remote. Under the "comprehensive allocation" approach, income tax expense encompasses any accrual, deferral or estimation necessary to adjust the amount of income taxes payable for the period to measure the tax effects of those transactions included in pretax accounting income for that period. The Board concluded that "comprehensive allocation" should be applied because "tax effects should be matched with or allocated to those periods in which the initial

¹²Ibid., p. 162.

¹³Ibid., pp. 164-168.

differences reverse. The fact that when the initial differences reverse other initial differences may offset any effect on the amount of taxable income does not . . . nullify the fact of the reversal."¹⁴

Discussion of Board position.--In differentiating between the "deferred method" and the "liability method," the Board considered only the advisability and practicality of modifying the deferral for changes in tax rates or tax structure. Essentially, then, the two approaches differ only in application. Both reflect a liability concept toward future tax reversal. Both apply allocation on a transaction by transaction approach.

The primary difference between "partial allocation" and "comprehensive allocation" is a difference in the concept of liability envisioned by the supporting groups. Partial allocation requires that a significant probability of aggregate reversal be in evidence before deferral is recognized while comprehensive allocation conservatively assumes that individual reversal is inevitable. The two concepts of degree of payability and transactional allocation require serious consideration.

Interperiod tax allocation, as defined by the Board, implies a restriction placed upon current net income and a liability created to represent future expected cash flows

¹⁴Ibid., p. 167.

for tax reversal on individual assets. Taxes are similar to salaries--both require cash out-flows. Salaries are accrued when payment has not yet been made, but the amount and timing of the cash flow is determinable. Taxes, under comprehensive deferral, are accrued even though the amount and timing are not determinable because of the possibility of future offsetting timing differences. This is conservative accounting but not necessarily consistent accounting. Partial allocation would permit the accrual of taxes when the amount and timing are determinable. This practice would be consistent with current accrual accounting practice for other liability items. The estimated contingent liability, the timing of which is not determinable, could be reported as a footnote to the financial statements--a practice which is followed for other contingent liabilities.

It is obvious for any single asset, if the service life is properly estimated, that the total amount of depreciation taken will be the same regardless of the depreciation method employed. Use of an accelerated method for tax purposes and a straight-line method for books results in a timing difference in the net income generated which completely reverses itself over the life of the asset. Postulating an asset costing \$15,000, having a five year life, straight-line depreciation for book purposes and sum-of-the-years digits for tax purposes, the following example presents this complete reversal in terms of the depreciation charges.

DEPRECIATION CHARGES

	<u>Years</u>				
	1	2	3	4	5
	(\$)	(\$)	(\$)	(\$)	(\$)
Tax Return Depreciation	5,000	4,000	3,000	2,000	1,000
Book Depreciation	<u>3,000</u>	<u>3,000</u>	<u>3,000</u>	<u>3,000</u>	<u>3,000</u>
	2,000	1,000		(1,000)	(2,000)

It is on the basis of reasoning such as the above that the Board rests its transactional allocation. If federal income tax was assessed on income generated by individual assets, this assumption might be justified. But as Sidney Davidson indicates, the tax is based on taxable income of the entity (an ever changing, interacting bundle of assets).¹⁵ He presented a model of a static firm which used accelerated depreciation for tax purposes and straight-line for its records. This firm replaced its assets as their economic usefulness ended. He showed that, once the system stabilized, neither method would record more annual depreciation than the other. During the stabilization process, more depreciation would be taken for tax purposes than would be taken on the books. If the firm were using comprehensive tax allocation, it would have deferred the tax effect of the timing difference while no reversal would ever result unless the firm began to disinvest. In other words, if the tax laws remain relatively

¹⁵Sidney Davidson, "Accelerated Depreciation and the Allocation of Income Taxes," The Accounting Review, XXXIII, No. 2 (April 1958), 177.

constant and a firm replaces its assets at the end of their economic life, a deferral will arise initially and will not reverse. Davidson also postulates a growing firm and, predictably, comprehensive tax allocation would produce a growing deferral in this case.

The Accounting Principles Board, by attempting to define one practice suitable for all firms, has adopted what appears to be a questionable rule. If the Board's concern was providing for future tax reversal, the investment policy of the individual firm best determines the existence and timing of such a reversal. In other words, where firm policies indicate that a reversal is probable, tax allocation should be employed. Where the policies of the firm preclude the possibility of a foreseeable reversal, tax allocation may be irrelevant and misleading.

Interstate Commerce Commission position.--A statement of policy was presented by the Interstate Commerce Commission on February 9, 1959, relative to the tax treatment to be followed if accelerated depreciation were to be followed for tax purposes. The Commission states the reasoning behind its prescription of flow-through accounting for such tax benefits:

When an available depreciation allowance produces a reduction in Federal income taxes, no matter how temporary the benefit may be the effect on net income should be the same as a reduction in taxes produced by lower tax rates. Possible income taxes to be assessed in the future are not an element of tax expense for the current

year. As to depreciable property with an expected life of thirty years, or even less, it is illogical to expect that tax reductions resulting from accelerated depreciation allowances can be matched with tax increases of the future. New property units acquired in the future will provide increased depreciation allowances to offset decreasing allowances for older units. Furthermore, income tax rates and tax procedures are subject to change from year to year, and the computation of income taxes differs as between carriers, and for any carrier differs as between years, in too many respects to justify special provision for a fluctuation in taxes resulting only from depreciation allowances.¹⁶

The carriers were then directed to report the annual tax savings and the cumulative amount to date in their annual reports to the Commission. On February 1, 1963, the Commission issued its order relative to guideline lives and the investment credit.¹⁷ In the report, the Commission indicates that most respondents to the proposed rule-making of November 8, 1962,¹⁸ favored flow-through in accounting for these two tax provisions.¹⁹

They express the view that actual taxes payable for each year, based on the effective tax regulations of the year, is the only liability to

¹⁶Interstate Commerce Commission, Accounting for Federal Income Taxes, 24 F.R. 1401.

¹⁷Interstate Commerce Commission, Accounting for Federal Income Taxes Under New Depreciation Guideline Lives and Investment Tax Credit, Docket No. 34178, Service Date February 13, 1963.

¹⁸27 F.R. 10909.

¹⁹Interstate Commerce Commission, Accounting for Federal Income Taxes Under New Depreciation Guideline Lives and Investment Tax Credit, p. 4.

the Government and the true amount to be recorded in the corporate accounts and financial statements each year for tax expenses; and that when taxes so computed are reported in the tax return for a year no deferred-tax liability remains unpaid for the year and no amount should be recorded in the accounts and financial statements for unpaid taxes or for tax-liability contingency.

In opposing tax-deferral or tax-equalization accounting procedures the opponents declare that the ever-changing tax system does not lend itself to interperiod tax allocation because of uncertainties associated with such allocation; and that tax reductions resulting from tax-depreciation guideline lives and investment tax credit are just as real as though statutory tax rates were decreased.²⁰

The railroad industry overwhelmingly endorsed flow-through accounting as, of the respondents to the proposed rule-making, 82 per cent of the railroads supported flow-through while 18 per cent was opposed.²¹ Division 2 of the Commission issued the February 1 report which in essence instructed all carriers subject to the prescribed accounting rules to apply the flow-through method in recording federal income taxes. "Subsequent developments and happenings have tended in our opinion to confirm the wisdom of the Commission's decision in this area of accounting."²² The reduction in income taxes from use of accelerated depreciation methods, guideline lives and the investment credit, for one Class I railroad, aggregated \$87 million for the years 1962 to 1964.

²⁰ Ibid.

²¹ Ferris, p. 28.

²² Ibid., p. 29.

"Had the Commission selected the tax deferral or normalization method, a total of over \$127 million would have been removed from net income and set up as a balance sheet reserve. (The excess over \$87 million covers reduction from accelerated amortization of emergency facilities.) Using the actual federal income tax liability of \$23.3 million for 1964 as generally representative, it can be seen that the reserve of \$127 million would be equivalent to over 5 full years' income taxes."²³

Although the Commission prescribed flow-through accounting for federal income taxes, the results would have been similar had it prescribed partial allocation. As the above quotation indicates, the present justification of this past action could be that asset turnover has kept taxes low. But it has been predicted that, unless the railroad industry receives some sort of special tax treatment by the 1970's, some, at least, may demand that some form of tax allocation be included in the Uniform System.²⁴ Rua and Murphy are convinced that the long lives of the railroad assets have prolonged the period during which flow-through accounting has benefitted financial reporting, but the day of reckoning

²³Ibid., pp. 29-30.

²⁴From interviews, October 24, 1967 and January 24, 1968, respectively, with Ernest J. Rua, Jr., of Peat, Marwick, Mitchell & Co. and Howard Dudley Murphy of Price, Waterhouse & Co.

may be approaching. This conviction is based upon the fact that the reversal for an asset which has a thirty-three year life should occur between the tenth and eleventh year (assuming double-declining balance depreciation for tax purposes and straight-line for books). Rolling stock, the chief railroad depreciable asset has an average life of about thirty years. Since railroads began using flow-through accounting in 1958, the first reversals should begin to be found on individual assets about 1969. By the 1970's, a substantial number of assets should have experienced reversals--possibly bringing about pressure for tax allocation procedures.

The arguments posed by Rua and Murphy may be invalid if reference is made to the Commission's statement in Chapter II and the proposition advanced herein that, so long as assets are replaced at the end of their useful life, deferral is unnecessary because aggregate reversal is not possible. In other words, if the railroads have made annual dollar investments in new assets at least equal to the dollar value of those assets which became no longer subject to depreciation in that year, no aggregate reversal will occur and taxable income will not exceed pretax accounting income.

Railroads are like other business firms in their planning in that forecasts are made of future income and future income taxes. It should be possible for them to determine, in advance, the amount and timing of any aggregate

tax reversal. The Interstate Commerce Commission, as indicated in Chapter II, requires that excess depreciation taken for tax purposes be reported, in hopes that it may be able to anticipate any future tax reversals and the effect on the transport system.²⁵ Its argument against tax allocation is primarily the speculative nature of the future liability; ten years of flow-through accounting has not shown the need for tax allocation. Although the Commission will not permit any form of tax allocation at the present time, it stands ready to reevaluate its position and may permit partial allocation based upon a liability concept should the transport system find itself in need of such an accounting method.

Betterment Accounting

"Betterment" or "replacement" accounting, under the Interstate Commerce Commission's rules, means that "the property account contains only that portion of the track structure which constitutes a quantity increase or quality improvement. This is accomplished by capitalizing the first installation and thereafter only capitalizing that portion of the replacement constituting the quality improvement (the 'betterment')." ²⁶ For example, assume a section of 90 lb. rail were to be replaced by a section of 120 lb. rail. The

²⁵ See Chapter II, n. 38 and following.

²⁶ "Railroad Accounting Procedures," p. 72.

labor would be charged to expense; the current cost of a section of 90 lb. rail would be charged to expense; the difference between the current cost of 120 lb. rail and 90 lb. rail would be added to the property accounts. The analogy may be drawn to the replacement of tires, spark plugs, and other such items on an automobile. If there is no change in quality, betterment accounting conforms exactly to LIFO inventory accounting. The Association of American Railroads justifies the use of betterment accounting through statements made by the accounting profession, the courts, and the Interstate Commerce Commission. The Committee on Accounting Procedure approved the 1957 report of the Committee on Relations with the Interstate Commerce Commission in which the following statement may be found:

. . . As to track components, however, the committee, in consideration of the long history of the use of replacement accounting by railroads with respect thereto, the unique nature of this category of railroad property, its relatively stable physical quantity, and the mature economic status of the industry, has concluded, with one member dissenting, that no substantial useful purpose would be served by a change to depreciation accounting techniques in the absence of evidence indicating that depreciation maintenance procedures would provide more appropriate charges to income for the use of such property.²⁷

²⁷Report reproduced in: Arthur Andersen & Co., Cases in Public Accounting Practice, Vol. VII: Interstate Commerce Commission Jurisdiction Over Financial Statements in Reports to Stockholders (Chicago: Arthur Andersen & Co., 1962), p. 24.

The justification of the courts can be found in a case heard in 1935, in which the court said:

. . . It would be inconvenient, if not impractical in railroad accounting to charge every item having a life of more than one year to capital account and allow depreciation on it as a deductible item of expense; and in a great business where thousands of similar replacement or repair items are involved nothing would be gained by such a system of accounting, since, on the law of averages, expenditures for such items during a given year would substantially balance the depreciation for that year. The proper accounting practice, therefore, is to allow normal expenditures for repairs and replacements as an expense of the business and not to allow depreciation on such items except to the extent that it may not be covered by expenditures for repairs and replacements.²⁸

The Interstate Commerce Commission justifies this treatment for basically the same reasons used by the Committee of the American Institute. When the Uniform System of Accounts was established in 1914, betterment accounting was firmly established as the method of providing for capital maintenance.²⁹ This method was adopted by the Commission in accordance with its policy of choosing, for the Uniform System, the generally accepted and most acceptable practices in use at the time.³⁰ Even the growth of depreciation accounting in other industries and the acceptance by the Commission of depreciation accounting for other property items have not threatened

²⁸Southern Ry. Co. v. Commissioner of Internal Revenue, 74 Fed. 2d 887 (4th Cir. 1935).

²⁹Hendriksen, p. 34.

³⁰Ferris, p. 14.

betterment accounting for track components. Beside the fact that betterment accounting has a long history, there are numerous practical difficulties that would be entailed in changing over to depreciation accounting:

1. The use of rail first on main line and its subsequent removal to secondary and then to branch lines; also the serious problem of valuation of used rail.
2. The determination of units of property which is an extremely debatable subject. Ties are seldom replaced in a continuous stretch but usually through replacement programs of every fourth or fifth tie. Thus attempts to specify any continuous length of ties would probably not give a satisfactory result while an individual tie is too small a unit for practicality. It might be conceded that 1400 feet would be an appropriate unit for rail.
3. Ballast is seldom replaced, any annual charge could only be an estimate of the wastage within the given period.
4. The change would require restatement of the assets to a historical figure predicated on the newly defined units of property with some provision for accumulated depreciation.³¹

These practical difficulties should not, however, prevent change over if depreciation accounting in fact produces more reliable results. The difficulty is that no information is available as to the dollar differences between the two methods. During the hearings of the Subcommittee on Legal and Monetary Affairs of the Committee on Government Operations of the House of Representatives, the Subcommittee Counsel, Plapinger asked the following question and received the attendant answer from Howard D. Murphy, who was then

³¹Adapted from: "Railroad Accounting Procedures," p. 73.

Chairman of the Committee on Relations with the Interstate
Commerce Commission:

Plapinger: "Was there any effort on the part of your committee to appraise the effect of a switch to depreciation accounting on the income of the railroads?"

Murphy: "There was not on the part of the committee. I tried myself to make an estimate several times on that, and I have had to admit defeat because of inability to answer the first question--what are the units of property, and what is the life of them."³²

Perhaps the best argument for the adoption of depreciation accounting for track components is an argument against the use of betterment accounting, since the dollar differences between the two approaches are impractical to determine short of full-scale change over. In fact, the Interstate Commerce Commission itself may have stated the case for depreciation accounting as succinctly as anyone:

As has been indicated, the carriers frequently adjust the amount of maintenance work done to the state of their earnings. They are liberal in such expenditures in times of prosperity, and curtail them in times of adversity. When earnings are poor, they may spend only enough on track and equipment to keep them in reasonably safe condition, deferring other desirable expenditures until more favorable times, if they ever arrive. If depreciation accounting were applied to track material, the opportunity for such variations in maintenance charges would be reduced,

³²Arthur Andersen & Co., Letter to American Institute of Certified Public Accountants Requesting Reconsideration of Its Position Regarding Replacement Accounting in the Railroad Industry (Chicago: Arthur Andersen & Co., September 17, 1963), p. 8.

and the situation as to track would be similar to that which now exists as to equipment. Actual expenditures could be curtailed as much as at present, thus conserving cash, but there would be less opportunity for reduction in recorded operating expense.

While the executives prize the present opportunity to control and adjust maintenance expense to changing financial conditions, the extension of depreciation charges to the track accounts would undoubtedly result in a more accurate statement of the actual expense which is being incurred in the operation of the property, and one less apt to mislead both investors and the public generally. We believe that such a result is greatly to be desired. The problem presented by the recurrent peaks and valleys of railroad traffic ought not to be met by incomplete and misleading statements of operating expense.³³

Howard Dudley Murphy presents an argument for retention of betterment accounting for track components on the basis that better cost control is achieved through its application than is achieved through the application of depreciation accounting.³⁴ About three times as many maintenance dollars are spent for depreciable assets as for betterment of track components so the distortion on asset values in the balance sheet may not be as great as imagined. Depreciation accounting spreads the effect of managerial

³³From Interstate Commerce Commission Case Number 15,100, decided July 28, 1931, pp. 438-439, as found in Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession (2nd ed.; Chicago: Arthur Andersen & Co., October 1962), p. 132.

³⁴Interview, January 24, 1968, with Howard Dudley Murphy of Price Waterhouse & Co.

action over future periods while betterment accounting presents the effect in the year of the action. No evidence has been presented as to the magnitude of the difference between the two approaches as applied to the American railroad industry. For the above three reasons, betterment accounting might be retained because of better cost control obtainable by management and because readers of financial statements can better evaluate managerial policies.

If conversion from betterment accounting to depreciation accounting for track components is deemed advantageous for either balance sheet or income statement reasons, two methods are available for the accomplishment of this objective. The first is to start from the time of policy change to capitalize all betterment expenditures and depreciate whatever asset balance is on the books. This method, because of the initially understated asset balance, will result in depreciation charges that would most likely be substantially lower than the comparable betterment charges that would have been made to income. This condition of income overstatement will continue until the original dollars in the asset account have been removed. If depreciation accounting is theoretically superior to betterment accounting, the sacrifice made in the measurement of income may be justified by the change to the theoretically better method. However, as has been indicated, it is not known whether depreciation accounting is superior as to income

measurement. No comparative results are available for American railroads.

The second method of implementing a change to depreciation accounting is a complete restatement of the assets and depreciation contra accounts such that a fresh start is made. It is possible to make a change-over to depreciation accounting for track components from betterment accounting and in a relatively short period of time. The Canadian Board of Transport Commissioners, in 1952, decided that Canadian railroads should make this transition. However, it took from 1952 until early 1955 to decide upon the units of property to be used, the method of valuing the "inventory" and the depreciation rates to be used.³⁵ The work on the inventory was started by the railroads in early 1955 and the restatement of the property accounts was reflected in the railroad annual reports for 1956. The Arthur Andersen & Co. report indicates that the adoption of depreciation accounting had no material effect on the net operating results for the year 1956 of either of the two Canadian railroads (Canadian National and Canadian Pacific) which converted from betterment accounting.³⁶ This indicates that there is perhaps less justification for the conversion to depreciation

³⁵ Arthur Andersen & Co., "The Canadian Experience with the Adoption of Depreciation Accounting for Railroad Track Structure and Grading Accounts," unpublished report (Chicago: Arthur Andersen & Co., March 7, 1966), pp. 3, 9.

³⁶ Ibid., pp. 17-18.

accounting for track components than there would be if material differences had been evidenced. The annual reports of these two major railroads disclosed the magnitude of the adjustments that were made to the property accounts. The Canadian Pacific indicated that an adjustment of \$213,788,319 was made to Gross Property Investment, a 12.3 per cent increase over the December 31, 1955 balance of \$1,761,669,249.³⁷ The adjustment made by the Canadian National was \$173,302,045, a 6.3 per cent increase over the December 31, 1955 balance of \$2,757,290,868.³⁸ This does not appear to reflect the adjustment of "grossly understated" asset balances which some argue that betterment accounting creates.

It would be very difficult to generalize the experience of two Canadian railroads to cover the expected experience of seventy-six Class I railroads in the United States. In other words, the issue as to whether or not depreciation accounting should replace betterment accounting for track components for American railroads must be decided on the basis of the relative merits as perceived by the railroads involved, the Interstate Commerce Commission, and other users of the information. It appears currently that the practical difficulties of change-over and the speculative

³⁷The 1956 Annual Report of the Canadian Pacific Railway Company, p. 26.

³⁸The 1956 Annual Report of the Canadian National Railways, p. 32.

nature of any benefits to be forthcoming stand in the way of eliminating betterment accounting from the Uniform System.

Summary

The two material divergences from generally accepted accounting principles, as practiced by other industries, exhibited by the Uniform System are in the areas of the treatment of federal income taxes and replacement or betterment accounting applied to track property. In the area of income tax accounting, it has been concluded that the deferred credit approach to tax allocation is questionable. If tax allocation is to be used at all, partial allocation based upon a liability concept appears the more acceptable approach. The railroads and the Interstate Commerce Commission favor flow-through accounting because of the speculative nature of any future liability. As indicated earlier, flow-through gives results similar to those obtained under partial allocation, when the future aggregate reversal is considered unlikely. The conclusion of this paper is that flow-through is preferable to predicting current income on speculative future tax reversals, the aggregate amount and timing of which are unknown or nonexistent. In the area of betterment accounting, in view of the weight of years of use and the practical as well as monetary consequences of change-over to depreciation accounting, the railroads may never conform to other industries. The only comprehensive evidence of the effect of a change from betterment accounting

to depreciation accounting indicates neither a material difference in the net income generated in the year of change nor a substantial reevaluation of assets. It is possible to agree with the Committee on Relations with the Interstate Commerce Commission that, because of the long history of railroad use of betterment accounting, the unique nature of this category of railroad property, its relatively stable physical quantity, and the mature economic status of the industry that betterment accounting is justifiable, as is depreciation accounting, for track components.

CHAPTER IV

RAILROAD FINANCIAL REPORTING

Introduction

This chapter contains an evaluation of the current state of the art of financial reporting in the railroad industry as it is reflected in the sample. In order to properly analyze the present state, a frame of reference was needed. Conformity with generally accepted accounting principles was selected as the standard, since the evaluation was made of published financial statements most of which were attested to by certified public accountants as to their fairness of presentation in accordance with such principles. A brief look at railroad financial reporting prior to 1962, the Arthur Andersen & Co. petitions, present financial reporting practices and the opinions of financial analysts relative thereto, opinions of the audited railroads, and conclusions as to the acceptability of current reporting comprise this chapter.

Financial Reporting Before 1962

Prior to 1961 annual reports, auditor's certificates related the financial statements of railroads to their conformance with the Uniform System. Two paragraph reports

predominated and the substance of the second paragraph would read substantially as follows:

In our opinion, the accompanying balance sheet and statement of earnings reinvested in the business present fairly the financial position at December 31, 19XX and the results of operations for the year then ended, in conformity with principles of accounting prescribed or authorized by the Interstate Commerce Commission applied on a basis consistent with that of the preceding year.¹

Railroads were not actually required to prepare their annual reports to stockholders in accordance with the Uniform System; they apparently prepared these reports in this manner because it was less complicated than conversion to another system and because the Interstate Commerce Commission had never made a formal statement to the effect that any other system was acceptable for this purpose.

Financial statements in annual reports to stockholders and otherwise released to the public are regularly prepared by carriers in conformity with rules in the uniform system of accounts and this Commission has not had occasion in the past to issue a general rule dealing with the question. . . .²

Financial statements in the stockholders' reports of railroads were based on accounting principles prescribed or authorized by the Commission, and it appears that the

¹Taken from the 1960 Annual Report of the Chesapeake and Ohio Railway Company, p. 30.

²Interstate Commerce Commission, Financial Statements to Be Consistent with Accounting Regulations, Notice of Proposed Rule Making dated September 16, 1960, Docket No. 33581.

railroads considered this mandatory; conversely, some of the other regulated transportation companies (trucking and interstate bus companies, for example) deviated from the Uniform System and reported on the basis of generally accepted accounting principles followed by other industries.³ Although there were divergences in financial reporting within the jurisdiction of the Interstate Commerce Commission, within the railroad industry uniform reporting was in evidence.

Another interesting factor about pre-1962 railroad annual reports relates to the proportion that were audited by certified public accountants. In a study conducted by the staff of Arthur Andersen & Co. of the 1961 annual reports of major railroad companies, 13 of the railroad financial statements, included also in the sample of 37 annual reports used in this paper, did not receive an independent audit.⁴ The sample of 1966 annual reports indicates that 6 were unaudited.⁵ The respective percentages, as related to the sample of 39 are 33.3 per cent and 15.4 per cent. The same six that were not audited in 1966 were

³Arthur Andersen & Co., Cases in Public Accounting Practice, Vol. VII: Interstate Commerce Commission Jurisdiction Over Financial Statements in Reports to Stockholders (Chicago: Arthur Andersen & Co., 1962), p. 1.

⁴Arthur Andersen & Co., Subject File No. 2030, Item No. 51.

⁵This includes two which received audit opinions only on the financial statements of consolidated subsidiaries.

represented in the thirteen unaudited in 1961. The reason for the large percentage of unaudited railroad annual reports is quite simple: the regulations of the Interstate Commerce Commission, the Securities and Exchange Commission, and the New York Stock Exchange specifically exempt these enterprises from this requirement. There appears to be a trend, as evidenced by the period from 1961 to 1966, for fewer railroads to remain without auditors possibly because of the tremendous debt financing required by the industry.

As indicated in Chapter II, the 1957 report of the Committee on Relations with the Interstate Commerce Commission proposed modifications in the Uniform System which were, with two major exceptions, approved by the Commission and incorporated January 1, 1958. These, and other changes over time, have improved the financial reporting of railroads using the Uniform System as the basis upon which their reporting was founded.

According to my score card, the first complete system of accounts, issue of 1914, was amended 71 times. The following issue of 1943 was amended 37 times, the issue of 1952 a total of 11 times, the issue of 1957 a total of 10 times and the currently effective issue of 1962 already has been amended 5 times. If you will add up these figures you will find that the rules have been amended 134 times since 1914. I will leave you to judge whether a backward and unprogressive agency living in the days of the past could have established this record.⁶

⁶Richard J. Ferris, Assistant Director, Bureau of Accounts, Interstate Commerce Commission, "The Uniform System of Accounts; Development and Performance," a speech

Even allowing for the revisions, the Uniform System, as a basis for financial reporting, continues to be criticized.

The Arthur Andersen & Co. Petitions

The following is a historical sketch of the events leading up to the Interstate Commerce Commission's decision to allow carriers subject to its regulation to base their annual reports to stockholders on generally accepted accounting principles.⁷

On May 4, 1959, Arthur Andersen & Co. submitted a petition to the Interstate Commerce Commission requesting that the latter render a decision as to whether or not railroad companies and other carriers subject to Section 20 of the Interstate Commerce Act (the Hepburn Act) are required to use the prescribed accounting practices for financial reporting to parties other than the Commission.⁸ On September 16, 1960, the Commission issued a Notice of Proposed Rule Making which stated:

No carrier subject to accounting regulations prescribed by this Commission shall distribute in its annual reports to stockholders or otherwise release to the public financial statements

before the Seventy-first Annual Meeting, Accounting Division, Association of American Railroads, May 31, 1966, pp. 49-50.

⁷This history may be found in Arthur Andersen & Co., pp. 6, 10, 50.

⁸Petition reproduced in ibid., pp. 41-45.

which are inconsistent with the corporate books of account, maintained in conformity with the uniform system of accounts prescribed by the Commission, and with reports filed with the Commission for or on behalf of the carrier. This rule shall not be deemed to prohibit distribution or publication of reasonable condensation or rearrangement in the form of financial statements in annual reports to stockholders or otherwise released to the public or of special statements pursuant to requirements of indentures or mortgage to secure bonds or other similar instruments.⁹

The Commission, in order to be fully advised, solicited data, views, and comments in writing from all interested persons and indicated that oral argument or a public hearing could be arranged if the interested persons should request it.¹⁰ No oral argument or public hearing was ever held even though one was requested in a letter from The Greyhound Corporation dated March 13, 1961¹¹ and in a petition by Arthur Andersen & Co. dated November 1, 1960.¹² Written views and comments were received by the Commission from the American Institute of Certified Public Accountants, 16 public accounting firms (including five of the "Big Eight"), one bank, the Investment Bankers Association of America, the New York Stock Exchange, 22 trucking companies and associations and from seven other transportation companies and associations

⁹Notice reproduced in ibid., pp. 48-49.

¹⁰Ibid., p. 49.

¹¹Letter reproduced in ibid., pp. 131-132.

¹²Petition reproduced in ibid., pp. 57-59.

(including one railroad).¹³ The effect of these letters to the Commission is as presented in Table 1. It appears then

Table 1. Responses to proposed rule making on financial reporting

	Total	In Favor	Opposed
Accounting profession	17	0	17
Institutions	3	0	3
Trucking	22	1	21
Other transportation	7	0	7

that 97.9 per cent of the respondents opposed the Proposed Rule Making. The American Institute of Certified Public Accountants emphasized the public interest in its statement:

The managements of private enterprises have a responsibility and the freedom to report financial information to investors and creditors in a manner designed to best serve the needs of such investors and creditors. There would seem to be no good reason why the managements of companies subject to the Commission's jurisdiction should not have the same responsibility and freedom to make such reports as do the managements of other private enterprises.¹⁴

The Commission considered it unnecessary to hold a public hearing. On January 25, 1962, it withdrew the proposed rule and issued its decision and order permitting carriers to

¹³Letters reproduced in ibid., pp. 55-136.

¹⁴Letter reproduced in ibid., pp. 55-56.

prepare financial statements to stockholders and others in conformity with generally accepted accounting principles.

Many responses have been received from carriers and others, including the American Institute of Certified Public Accountants and individual firms of certified public accountants, who audit financial statements of carriers, expressing opposition to the proposed rule. The substance of these objections is that the Commission should not as a matter of policy deny the carriers the right to furnish their stockholders or to otherwise publish financial statements based on accounting methods for which there is substantial authoritative support under generally accepted accounting principles.

In our opinion, the following rule is reasonable: Carriers desiring to do so may prepare and publish financial statements in reports to stockholders and others, except in reports to this Commission, based on generally accepted accounting principles for which there is authoritative support, provided that any variance from this Commission's prescribed accounting rules contained in such statements is clearly disclosed in footnotes to the statements.¹⁵

By requiring footnote disclosure of variances between the two systems when generally accepted accounting principles were used, the Commission insured that the parties desiring financial statements prepared on the basis of the Uniform System could acquire that information by making the appropriate adjustments. At the same time, the integrity of the Uniform System was not being threatened; the reporting requirements to the Commission remained unchanged. The order was not to become effective until July 1, 1962, but certified public accounting firms changed their opinions to

¹⁵Reproduced in ibid., pp. 50-54.

begin to compare the financial statements of railroads with generally accepted accounting principles with the 1961 annual reports.

Present Reporting

As indicated in Chapter I, certified public accountants are required to base their statement of opinion upon fairness of presentation in accordance with the consistent application of generally accepted accounting principles.¹⁶ The railroad industry is not required to apply these principles in its reporting to stockholders and in fact, is required to use The Uniform System of Accounts for Railroad Companies for its bookkeeping and for reporting to the Interstate Commerce Commission. The Securities and Exchange Commission and the New York Stock Exchange specifically exempt railroads from following generally accepted accounting principles by accepting reports prepared for the Interstate Commerce Commission in lieu of audited annual reports. The railroads are, therefore, in the curious situation of having their annual reports evaluated on one basis by certified public accountants while in fact this reporting may correspond to another basis. This "difference in perspective" is aptly illustrated in the following, which was prepared from the opinion certificates and footnotes to the

¹⁶See Chapter I, n. 1 and following.

railroad financial statements of the thirty-one annual reports in the sample that were audited. For eight railroads the auditors' opinions indicated that the Uniform System was the basis for financial reporting while twenty-five of the railroads indicated that they were using the Uniform System as the basis of accounting in their annual reports. This apparent lack of uniform perception will be investigated more fully in Chapter V. For the moment, it is sufficient to say that even relatively sophisticated users of railroad annual reports might be misled by the auditors' opinions because the basis upon which the statements are presented is not uniformly disclosed by the auditors.

Analyzing the number of railroads apparently following each basis of reporting by the size of the company reveals the following information (Table 2). It appears to

Table 2. Sample of 1966 annual reports--reporting basis by size of railroad

	Total Operating Revenue (in millions)				Total
	0- \$100	\$100- \$200	\$200- \$300	Over \$300	
Number reporting according to GAAP	4	0	2	0	6
Number reporting according to ICC	<u>12</u>	<u>3</u>	<u>8</u>	<u>8</u>	<u>31</u>
Total	16	3	10	8	37

be significant that smaller railroads have a greater tendency to report according to generally accepted accounting principles while larger ones prefer to base their reporting on the Uniform System of Accounts. One reason for this situation is the negative effect on the net income of most of the firms that would result from conversion. The distribution of the sample by auditor is presented in Table 3. It appears to be significant that specialization has occurred in the auditing of railroads. Five of the "Big Eight" certified public accounting firms audited the 31 railroads in the sample with three firms accounting for 87.1 per cent of these audited roads.

Table 3. Sample of 1966 annual reports--distribution by auditor

	Number	Per Cent
Haskins & Sells	9	29.0
Peat, Marwick, Mitchell & Co.	8	25.8
Price Waterhouse & Co.	10	32.3
Arthur Andersen & Co.	3	9.7
Ernst & Ernst	<u>1</u>	<u>3.2</u>
Number audited in sample	31	100.0

Since the Interstate Commerce Commission requires that the amount of deferred tax savings be disclosed in reports to the Commission, the railroads will report this amount and often the cumulative amount in footnotes to the published financial statements. It is not a requirement, however, that a reconciliation be presented to explain the difference between the net incomes on the basis of generally accepted accounting principles and the Uniform System of Accounts unless the former is used as the basis for financial statement presentation. There were 11 railroads which reported such a reconciliation, 9 of these did not need to because their reporting was based upon the Uniform System. It is apparent that the Commission's requirement of a reconciliation when generally accepted accounting principles are applied is satisfied by scattered notes to the financial statements. The results, by auditor and by type of reconciliation, are presented in Table 4. It appears to be significant that clients of Price Waterhouse & Co. are more prone to disclose this reconciliation than are the clients of other independent accountants. This may result from more progressive management on the part of the clients or from successful suggestion on the part of the auditor.

The information presented in Table 5 suggests that a close look should be taken at the six firms in the sample that were unaudited. These six firms, comprising only about

Table 4. Number of firms presenting reconciliation between bases of accounting by auditor

	Notes to State- ment	On the Income State- ment	Supple- ment to Income Statement	Total
Haskins & Sells	0	0	1	1
Peat, Marwick, Mitchell & Co.	0	1	0	1
Price Waterhouse & Co.	3	3	1	7
Arthur Andersen & Co.	0	0	1	1
Ernst & Ernst	0	0	0	0
No auditor	0	0	1	1

Table 5. Coverage of Class I railroad sample provided by the unaudited portion of the sample

<u>Number of Class I railroads</u> <u>in sample</u>	37	
Number unaudited in sample		6
Per cent		16.2%
<u>Total operating revenues</u> <u>in sample</u>	\$9,284,103,000	
Total operating revenues of six unaudited in sample		\$2,743,979,000
Per cent		29.5%
<u>Net railway operating income</u> <u>in sample</u>	\$1,008,133,000	
Net railway operating in- come of six unaudited in sample		\$ 317,695,000
Per cent		31.5%
<u>Net income in sample</u>	\$ 806,471,000	
Net income of six unaudited in sample		\$ 276,878,000
Per cent		34.3%

8 per cent of the Class I railroad industry, account for over one-third of the net income for the sample. Table 6 presents a size breakdown of audited versus unaudited railroads in the sample.

Table 6. Sample of 1966 annual reports--audited v. unaudited by size of railroad

	Total Operating Revenue (in millions)				Total
	0- \$100	\$100- \$200	\$200- \$300	Over \$300	
Number audited	14	3	10	4	31
Number unaudited	<u>2</u>	<u>0</u>	<u>0</u>	<u>4</u>	<u>6</u>
Total	16	3	10	8	37

The railroads that are unaudited are not evenly distributed over the continuum from the smallest to the largest. Rather, they are bunched at both ends. There may be some significance attached to this distribution as the small unaudited railroads (Maine Central and Lehigh Valley) operate primarily in local areas servicing specialized needs while the large unaudited railroads (Atchison, Topeka and Santa Fe, Pennsylvania, Southern and Union Pacific) are old, well-established, massive enterprises. There are more and more railroads becoming involved in holding company activities. Holding company activities are subject to the regulation of the

Securities and Exchange Commission. Therefore, the trend toward more complete auditing of the railroad industry should continue. These six unaudited railroads account for only about one-sixth (16.2%) of the 37 in the sample but they are responsible for over one-third (34.3%) of the net income of the sample.*

Because certified public accountants are required to relate their statements of opinion to the application of generally accepted accounting principles, the majority (27) of the 31 audited annual reports received qualified opinions. As has previously been indicated, most (25) of these 31 firms indicated that they were using the Uniform System of Accounts as the basis for financial reporting, and, since it differs from generally accepted accounting principles, either a qualified opinion or an adverse opinion would be required. The rationale for the qualified opinion rather than the adverse opinion will be pursued in Chapter V. Table 7 presents the distribution of qualified v. unqualified opinions rendered by auditor. It can be seen that 87.1 per cent of these opinions were qualified, a situation that could not be found in other industries. Analysis of this distribution by size of the firm yields the results shown in Table 8.

*Three of these railroads have communicated the intention of presenting audited financial statements for the year ended December 31, 1967.

Table 7. Sample of 1966 annual reports--distribution of audit opinions

	Unqualified	Qualified	Total
Haskins & Sells	1	8	9
Peat, Marwick, Mitchell & Co.	1	7	8
Price Waterhouse & Co.	2	8	10
Arthur Andersen & Co.	0	3	3
Ernst & Ernst	<u>0</u>	<u>1</u>	<u>1</u>
Total	4	27	31

Table 8. Sample of 1966 annual reports--audit opinions by size of firm

	Total Operating Revenue (in millions)				Total
	0-\$100	\$100-\$200	\$200-\$300	Over \$300	
Number of unqualified opinions	2	0	2	0	4
Number of qualified opinions	<u>12</u>	<u>3</u>	<u>8</u>	<u>4</u>	<u>27</u>
Total	14	3	10	4	31

Unqualified opinions tended to be issued to smaller railroads since, of the eight railroads with over \$300 million of operating revenue, four were not audited and the other four received qualified opinions. The primary reason for qualified opinions was lack of tax allocation as Table 9

Table 9. Sample of 1966 annual reports--reasons for qualified opinions

	Lack of Tax Allocation	Inadequate Depreciation Reserves	Treatment of Property Tax Refunds	Amortization of Other Elements of Investment	Total
Haskins & Sells	8	0	0	0	8
*Peat, Marwick, Mitchell & Co.	6	0	0	2	7
Price Waterhouse & Co.	7	1	0	0	8
Arthur Andersen & Co.	2	0	1	0	3
*Ernst & Ernst	0	1	0	1	<u>1</u>
					27

*There were 27 qualified opinions issued. In each of the starred cases, one opinion contained two exceptions.

reveals. None of the qualified opinions was for the use of betterment or replacement accounting in lieu of depreciation accounting for track components. Arthur Andersen & Co. qualified its opinions on the financial statements in the 1956-61 annual reports of the Chicago and North Western Railway Company for this reason but has discontinued this practice. It feels that, until a definitive statement has been made by the Accounting Principles Board or some other body with authoritative support, it is unduly penalizing its clients relative to other railroads should it qualify its opinions for this reason while other certified public accounting firms do not.¹⁷

The impact of betterment accounting on the net income of a railroad was referred to in Chapter II. The effect of the procedure is to expense the current replacement cost of the item being replaced and the labor involved in the replacement while leaving the cost of the original in the asset account. One of the issues raised was the difficulty of determining the difference between the depreciation expense and the betterment expense for any one year, assuming that depreciation accounting had been used rather than betterment accounting. From the annual reports in the sample, thirteen presented the dollar amount of betterment expenditures for 1966, a total of \$161,842,474. This

¹⁷From an interview, October 23, 1967, with Delbert Wacker of Arthur Andersen & Co.

represents 30.5 per cent of the \$530.4 million of net income for these railroads before the deduction for betterment. These expenditures may therefore be considered significant. Some railroads listed the dollar amount of non-depreciable track property in lieu of the amount of betterment expenditures but not both. Table 10 is prepared from the 1966 Annual Report of the Chicago, Rock Island and Pacific Railroad Company.

Table 10. Chicago, Rock Island and Pacific Railroad Company--non-depreciable track components and betterment expenditure

	1965	1966
Non-depreciable assets	\$254,892,487	\$253,270,545
Replacements and betterments	13,752,637	14,159,197
Per cent of asset	5.4%	5.6%
Appropriate asset life*	18.5 years	18.1 years

*This asset life assumes that replacements and betterments are approximately equivalent to the depreciation that would be taken on the asset if depreciation accounting were applied.

This was the only company in the sample that disclosed both of these figures. The percentage figures in the table are a bit misleading in that the dollar value for the non-depreciable track components represents the historical cost of the original track components plus the quality improvement over time while the dollar value for replacements and betterments

is the current cost of track components and the labor involved. Also, betterments and replacements include maintenance elements as well as the depreciation element. The betterment expense, the counterpart of depreciation and maintenance expenses, would indicate about an eighteen year life for track components while the actual life is considerably longer. The application of depreciation accounting would divide this charge into the depreciation and maintenance elements.

It was possible to establish that a relationship exists between earnings and betterment expenditures. This conclusion was premised on a quotation in Chapter III which indicated that carriers adjust their betterment expenditures depending upon financial ability.¹⁸ For only three railroads, it was possible to obtain from the 1962-66 published financial statements the dollar amounts of betterment expenditures, gross operating revenue, net income, and revenue-ton miles.¹⁹ Gross operating revenue and net income before betterment expenditures were adopted as measures of financial ability while revenue-ton miles serves as an indication of track component usage. Table 11 presents the coefficients of rank correlation derived for these three companies.

¹⁸See Chapter III, n. 33 and following.

¹⁹Atlantic Coast Line, Delaware and Hudson, and Erie-Lackawanna.

Table 11. Correlation with betterment expenditures

	Atlantic Coast Line	Delaware and Hudson	Erie- Lackawanna
Gross revenue	.94	.37	.83
Net income	.94	.43	.94
Revenue-ton miles	.94	.09	.83

Although the coefficients of rank correlation for the Delaware and Hudson were low for all three relationships, the coefficient for net income is the largest. The Erie-Lackawanna showed a greater correlation with net income while the Atlantic Coast Line showed a high degree of correlation with all three. Data availability made it impossible to repeat this correlation analysis for a longer period of time. It is not possible to generalize from these results, but it is possible to state for these firms that a more than casual relationship exists between earnings and betterment expenditures. Usage and betterment expenditures seem to be less closely related to each other for two of these railroads.

Seventeen firms in the sample disclosed information about company sponsored pension plans. In two cases it was not possible to determine the accounting method employed by the company. Table 12 presents the data for the remaining

Table 12. Sample of 1966 annual reports--pension plan accounting methods

	Total Operating Revenue (in millions)				
	0- \$100	\$100- \$200	\$200- \$300	Over \$300	Total
Current expense only	1	0	0	0	1
Current and interest	3	0	1	0	4
Full recognition of past service	<u>2</u>	<u>2</u>	<u>1</u>	<u>5</u>	<u>10</u>
Total	6	2	2	5	15

fifteen classified by size of the firm. It appears significant that either larger firms have pension plans while smaller firms do not or that larger firms disclose these plans while smaller firms do not. It is also significant that, as the analysis moves from smaller to larger firms, the tendency for the railroads' pension plans to be fully accrued increases. The effect on earnings of these larger, more profitable railroads would be less than the effect on earnings of the smaller roads.

Interstate Commerce Commission requirements include depreciation accounting for certain kinds of assets. When these requirements were finally instituted, they were to apply to qualified assets acquired after January 1, 1943. The Uniform System of Accounts does not, therefore, authorize the depreciation of assets acquired before that date. Six

railroads in the sample disclosed that their published financial statements contained no depreciation on assets of this type. The Gulf, Mobile and Ohio Railroad Company, in the notes to the financial statements, states that "the Company has recorded the estimated accumulated depreciation applicable to depreciable property prior to January 1, 1943."²⁰ The Reading Company indicates that "except to the extent of approximately \$12,000,000" it remains "consistent with the practice generally followed by Class I railroads" in that "no provision was made for depreciation of road property prior to January 1, 1943."²¹ No exception was taken by any certified public accounting firm for not depreciating these assets. The effects on net income and financial position were not considered material or a qualification would have been given for that reason.

Although only eleven railroads prepared a reconciliation between net income on the basis of the Interstate Commerce Commission requirements and on the basis of generally accepted accounting principles, it was possible to make adjustments to the reported net incomes of twenty-eight firms, through generous use of the notes to the financial statements, to approximate a reconciliation. Table 13

²⁰1966 Annual Report of the Gulf, Mobile and Ohio Railroad Company, p. 12.

²¹1966 Annual Report of the Reading Company, p. 12.

Table 13. Sample of 1966 annual reports--reconciliation between bases of net income*

	Uniform System	Adjustment	After Adjustment
Atlantic Coast Line	\$ 22,048,000	(\$ 8,134,000)	\$ 13,914,000
Chesapeake and Ohio	66,096,033	(7,000,000)	59,096,033
Chicago, Burlington and Quincy	25,082,397	(4,300,000)	20,782,397
Chicago and Eastern Illinois	3,255,052	(1,556,000)	1,699,052
Chicago Great Western	1,396,036	(670,000)	726,036
Chicago, Milwaukee, St. Paul and Pacific	8,129,944	(5,643,576)	2,486,368
Chicago and North Western	26,074,648	(6,184,000)	19,890,648
Chicago, Rock Island and Pacific	7,433,887	5,536,339	12,970,226
Delaware and Hudson	5,104,410	(600,000)	4,504,410
Denver and Rio Grande Western	12,895,409	(2,411,067)	10,484,342
Great Northern	36,547,109	(2,400,000)	34,147,109
Gulf, Mobile and Ohio	7,487,779	(1,843,000)	5,644,779
Illinois Central	23,340,996	(5,479,000)	17,861,996
Louisville and Nashville	28,516,789	(8,666,000)	19,850,789
Missouri-Kansas-Texas	(7,834,989)	(1,409,793)	(9,244,782)
Missouri Pacific	26,747,000	(6,235,000)	20,512,000
Monon	1,717,756	(708,000)	1,009,756
New York Central	65,531,812	(12,000,000)	53,531,812
Norfolk Southern	(104,866)	(260,000)	(364,866)
Reading	1,592,081	(2,000,000)	(407,919)
St. Louis-San Francisco	12,384,000	(2,041,000)	10,343,000
Seaboard Air Line	16,113,988	(3,326,000)	12,787,988
Soo Line	6,532,485	(1,000,000)	5,532,485
Southern Pacific	102,372,379	(12,653,194)	89,719,185
Texas and Pacific	5,219,471	(2,367,000)	2,852,471
Union Pacific	109,791,622	(20,700,000)	89,091,622
Western Maryland	5,604,363	(1,226,000)	4,378,363
Western Pacific	<u>8,710,294</u>	<u>(2,016,000)</u>	<u>6,694,294</u>
Total	\$627,785,885	(\$117,292,291)	\$510,493,594

*The adjustments are primarily the tax effects of guideline depreciation, accelerated depreciation, amortization of defense facilities and other elements of deferred taxes.

presents this attempted reconciliation. The total net income of \$627,785,885, based on the requirements of the Uniform System of Accounts, would be reduced to \$510,493,594 if those listed at the end of the table were the only adjustments necessary to reconcile the two bases of reporting. The change amounts to 18.7 per cent of the total net income based upon the Uniform System's requirements. By firm, the range of percentage change is from 7 per cent to 248 per cent with the median change being 23 per cent. There was but one of the railroads, the Chicago, Rock Island and Pacific, whose net income based on generally accepted accounting principles was greater than the net income for Interstate Commerce Commission purposes. Presented on the basis of return on total assets employed, the adjustments produced a reduction of .57 per cent. The return, based upon net income determined according to the requirements of the Commission, was 3.01 per cent while the comparable return using the adjusted net income was 2.44 per cent.

Confusion created by this single factor, the magnitude of the dollar difference and the percentage difference, particularly when reflected on a per-share basis, was the major reason for the decision by the Illinois Central Railroad to revert back in 1966 to reporting the earnings of the railroad exclusively on the basis of the Uniform System of Accounts.

We made the decision to revert to our policy of reporting railroad [financial results] on an ICC basis for a number of reasons. The primary one was that reporting on generally accepted as well as ICC basis (ICC basis required by Commission) created a great deal of confusion both from the analysts' point of view, and particularly, newspaper reports of our earnings. Some publications would report both bases, some would report net income dollar amount on one basis and net per share on the other, often leading to complaints by analysts.²²

Opinions of Financial Analysts

Financial analysts, as sophisticated users of published financial statements, were contacted for their opinions on the relative applicability of the Uniform System and generally accepted accounting principles for railroad financial reporting. The annual reports of companies are distributed to stockholders and probably are used more for judging investment decisions than for any other single purpose. It would seem that the opinions of trained financial analysts as to the proper accounting basis for railroad reporting would be invaluable. A general conclusion will be stated at this point, to be more fully evaluated later. Financial analysts seem to feel that the requirements of the Interstate Commerce Commission are more relevant for railroad financial reporting because of the nature of the economic conditions facing the industry, primarily the federal income

²²Letter dated January 10, 1968, from G. K. Weigel, Vice President and Comptroller, Illinois Central Railroad.

tax environment which favors the railroads under this accounting system.

Since the Congress and the Treasury instituted new depreciation guidelines and the 7 per cent investment credit, controversy has existed over the differences between the accounting methods prescribed by the ICC and those endorsed by the accounting profession. On the surface, it has appeared to some trust officers and security analysts that Class I railroad earnings have been overstated and the apparent earnings recovery of recent years has been illusory in part.²³ Hayden, Stone, Incorporated disagrees.

This brokerage firm thinks that the rails will continue to enjoy large tax benefits indefinitely because of their unique situation. The guideline life established for fleet equipment was fourteen years while present average age of such equipment is about sixteen or seventeen years, quite close indeed. (But, this average age would indicate a service life of perhaps 25-35 years.) Many railroads, with sizable tax loss carry-forwards from accelerated depreciation, retirements, and abandonments have not yet taken advantage of the shorter depreciation guidelines. These railroads continue to use the lives, established by the Interstate Commerce Commission, which are longer than the guideline lives established for tax purposes. Since the

²³Hayden, Stone, Incorporated, Railroad Industry Review: 1967 (New York: Hayden, Stone, Incorporated, 1967), p. 43.

railroads have the option of adopting guideline lives at any time, Hayden, Stone, Incorporated feels that the present low effective tax rates--in 1966, federal income taxes averaged only 17 per cent of the Class I railroads' reported net income--must simply be thought of as likely to continue indefinitely, with an upward bias as the industry's gross revenue and net income rise by reason of anticipated industry growth.²⁴ When Congress reinstated the 7 per cent investment credit in 1967, a prior provision was modified to allow this credit to offset up to 50 per cent of an individual carrier's federal tax liabilities instead of the previously allowed 25 per cent. Hayden, Stone, Incorporated predicts that this should enable the Class I railroads to increase their earnings by as much as \$25 or \$30 million in 1967 and in succeeding years.²⁵ Additionally, such things as the recently approved merger between the Pennsylvania and New York Central railroads whereby small, deficit producing railroads are absorbed into a large system will allow for higher after-tax earnings because of utilization of tax loss carry-forwards as well as substantially better utilization of resources. Considering all of these factors, Hayden, Stone, Incorporated states that rail earnings are not overstated as presented on the basis of the Uniform System

²⁴Ibid.

²⁵Ibid., p. 44.

because of economic circumstances which are peculiar to this industry.

Karl Ziebarth, an analyst for the above mentioned brokerage firm, states that "the Uniform System of Accounts probably gives a better general picture (of railroads) than does the accounting basis used in industrial corporations."²⁶

The Uniform System of Accounts does, broadly speaking, impose greater comparability on railroad management than does so-called "generally accepted" accounting on industrial companies. However, a caveat must be given: one must become thoroughly familiar with the basis of the Uniform System of Accounts, in order to understand what the management of a railroad is doing.²⁷

Ziebarth feels that greater comparability is evident in railroad reporting than in the annual reporting of industrial corporations. However, it is apparent that he thinks that uninformed users of financial data had best refrain from attempting to analyze railroad annual reports. Generally accepted accounting principles may not lead to as much comparability but may be less likely to be misinterpreted by the less sophisticated user. "General acceptance" may profess substantive support to the financial statements, but the number of alternatives available under generally accepted accounting principles may make the presentation of

²⁶Letter dated January 11, 1968, from Karl Ziebarth of Hayden, Stone, Incorporated.

²⁷Ibid.

"true" net income less likely. Ziebarth states that the Uniform System requires full disclosure, more so than for industrial companies, but one must know where to look to find out what has happened. "From the point of view of the analyst, the railroad accounts are, once you master the intricacy of ICC accounting, quite reliable indications of the performance of the individual carrier and of the industry."²⁸

Ziebarth presents three arguments for the use for financial reporting of the Uniform System of Accounts: federal income tax structure, continuity, and the psychology of railroad management. He argues that the present system of special tax reductions for railroads is built around the existing ICC accounting system. Any change in this accounting system might hurt the railroads tax-wise or would require substantial changes in the tax laws, "which Congress might be loath to make."²⁹ The second reason is that, by using the same basic system of accounts for fifty-three years, the Interstate Commerce Commission has obtained long-term statistical data of considerable significance, which is not obtainable for any other industry.

It is interesting to note that consistency or continuity has been adjudged highly important by accountants as well as financial analysts. The independent auditor attests

²⁸Ibid.

²⁹Ibid.

that the generally accepted accounting principles have been applied consistently with those of the preceding year. In a recently published study, Andrew McCosh presents the results of a simulation designed to determine the differences resulting from the consistent application through time of various sets of accounting policies. His conclusion is, essentially, that consistency in accounting policies, however diverse these policies may be, will lead to earnings per share results that depict economic fluctuations more accurately and similarly than even moderately inconsistent applications of accounting policies, however initially similar these may have been.³⁰ In other words, when two companies are subject to the same economic fluctuations, their stockholders will receive information that is essentially identical if the companies use their accounting policies consistently through time, no matter how different these policies may have been initially. Restating this conclusion in the form of a recommendation, McCosh makes the following statements:

The results obtained in this research indicate that instead of trying to promote intercorporate comparability by making all firms use the same methods, those who seek to improve the usefulness of accounting should concentrate on getting companies to hold consistently to the accounting policies they now employ. In this way, the information made available to stockholders will be

³⁰Andrew M. McCosh, "Accounting Consistency--Key to Stockholder Information," The Accounting Review, October, 1967, p. 699.

made comparable as between companies, without forcing corporate management to use an accounting procedure they consider unsuited to their company.³¹

This argument supporting consistency, on the basis that better information is derived if policies are followed consistently, tends to reinforce Ziebarth's second reason for retaining the Uniform System.

The third reason for retention of the Uniform System advanced by Ziebarth was a psychological observation considered worth making: the railroad industry tends to oppose change of any sort with an almost frenzied determination to preserve the status-quo, so that any revisions in the railroad accounting system will, as a practical matter, be unlikely.³² It may be that railroad managements are simply conservative, old-fashioned, or stodgy but more likely they are convinced that the quality of results obtained and consistency of application are sufficient cause to remain adamant against change. Some railroad management conclusions about the Uniform System are presented later in this chapter.

As was indicated in the case of the Illinois Central's change back to the Uniform System for financial reporting, having two bases for financial reporting raises more problems than it solves. John Kaptain states that,

³¹Ibid., p. 700.

³²Letter from Karl Ziebarth.

while he believes generally accepted accounting methods to be more conservative and more desirable, "the investing public does not appear to recognize the distinction" between the Uniform System and generally accepted principles of accounting.³³ Ziebarth corroborates this comment in his explanation of the reason for the railroads not reporting according to generally accepted accounting principles.

A few years ago several railroads reported experimentally on a "generally accepted" basis. What happened was that the market did not increase the multiple to that of an industrial stock, instead, the lower earnings reported under the "generally accepted" basis were simply valued with the normal railroad multiple.³⁴

In other words, the lack of sophistication on the part of the investing public makes it impractical for railroads to report in any way other than in accordance with the regulations of the Interstate Commerce Commission. "From this, one would conclude that there is no incentive for the industry to change its system from the basis now prescribed by the ICC."³⁵

Ray E. Lee, Jr., an analyst with Francis I. duPont & Co. states another virtue of the Uniform System basis of financial reporting which could be lost to readers of annual

³³Letter dated November 29, 1967 from John Kaptain of Merrill Lynch, Pierce, Fenner & Smith, Inc.

³⁴Letter from Karl Ziebarth.

³⁵Ibid.

reports should a complete conversion to generally accepted accounting principles take place.

There is also a virtue to the present arrangement that railroads present a considerably more massive set of figures for inspection than does the average industrial company. Under any change to "generally accepted" principles, there is the practical danger that the companies would be allowed to reduce their presentations to the bare minimum figures given by others, in which any presumptive improvement in the overall system would be more than dissipated in end result.³⁶

The amount of financial and operating data disclosed by railroad companies is apparently useful to financial analysts in their evaluation of investment potential. Reduction in the amount of detail presented, should railroads deem it appropriate to conform their reporting to industrial standards, would apparently lead to a considerable reduction in the value of railroad annual reports.

It is significant that some financial analysts, the most sophisticated users of published annual reports, state that the Uniform System of Accounts, the requirement for record keeping and reporting to the Interstate Commerce Commission, best reflects the financial results for the railroad industry.

³⁶Letter dated February 20, 1968.

Railroad Questionnaire

A ten-question questionnaire was prepared and sent to the chief financial officer of each of the audited railroads in the sample (Appendix B). The goal of the questionnaire was to elicit responses from the railroads concerning the method of financial reporting used, the advantages and limitations of the Uniform System of Accounts, and any foreseeable modifications in the prescribed accounting requirements. Twenty-four of the thirty³⁷ questionnaires mailed were returned (80 per cent) and the greater proportion of the results are analyzed in this section. Part C of the questionnaire is analyzed in Chapter VI.

The first three questions are interrelated and must be analyzed jointly. Table 14 presents the responses to Questions A-1,2,3 and 4 and thus contains some conclusions about railroad views toward generally accepted accounting principles. Although 58 per cent of the respondents feel that the Uniform System restricts managerial freedom in reporting to financial statement users and 84 per cent indicate that generally accepted accounting principles are at least as meaningful as the Uniform System for this reporting purpose, only 8 per cent of the respondents purport to use

³⁷There were 31 audited annual reports in the sample, however, the Missouri Pacific owned 95.5 per cent of the stock of The Texas and Pacific Railway Company as of January 17, 1967, and the same officers control both companies.

Table 14. Questionnaire results (Questions A-1,2,3,4)

1. System of financial reporting used:	
a) Uniform System of Accounts.	29%
b) "generally accepted accounting principles."	8%
c) combination of (a) and (b).	63%
2. Fair presentation achieved?	
a) Yes.	96%
b) No.	0%
c) Not certain.	0%
No response.	4%
3. "Generally accepted accounting principles":	
a) are superior for railroad reporting.	42%
b) are equally as meaningful as Uniform System.	42%
c) are less meaningful than Uniform System.	0%
d) are not relevant to railroad reporting.	16%
4. The Uniform System <u>severely</u> restricts managerial freedom in reporting:	
a) Yes.	21%
b) Yes, but not severely.	37%
c) Does not restrict.	42%

generally accepted accounting principles as the basis for their financial statements and 96 per cent indicate that they believe their annual reports fairly present the financial position and results of operations for their company. One rationale for the nonuse of generally accepted accounting principles even though the results of their application is considered to be at least as meaningful as the results obtained from the use of the Uniform System could be the reason advanced by the Illinois Central.³⁸ The difference between the net income derived from the two bases of

³⁸See above, n. 22.

financial reporting is apparently not compensated for by the users of the financial statements. Therefore, the incentive to change to reporting according to generally accepted accounting principles is substantially reduced. Another reason for the continued use of the Uniform System as the basis for reporting to others than the Interstate Commerce Commission is reflected in the answers to Question 2. Since the books and records of railroad companies are required to be kept on the basis of the prescribed system and the financial statements, preponderantly prepared on this basis, apparently fairly present the economic circumstances of the firm, the incentive to prepare the financial statements on an alternative basis is substantially reduced. In answer to Question 1, 63 per cent of the respondents indicated that their financial reporting was a combination of generally accepted accounting principles and the Uniform System. But these roads did not incorporate tax allocation and depreciation accounting for track components into their reporting system. These being the significant differences between the two systems, this 63 per cent was considered to be reporting according to the Uniform System of Accounts.

In order to evaluate the benefit of improvement in railroad financial reporting, conformity of the Uniform System with generally accepted accounting principles, and the value of the Commission's attempts to mitigate the differences, the responses to Questions A-5,6 and 7 are presented

in Table 15. At least 69 per cent of the respondents state that railroads have problems of more significance than the improvement of financial reporting. Since 79 per cent feel that the Commission's attempts to conform the Uniform System with generally accepted accounting principles are leading to improvement in railroad financial reporting, one can conclude that the railroad companies would, at least for the present, prefer to maintain a passive role and allow the Commission to be the active party. There were 46 per cent of the respondents who indicated that the Commission might prescribe either depreciation accounting for track components or deferred income tax accounting with the preponderance considering the former to be more likely. Even though

Table 15. Questionnaire results (Questions A-5,6,7)

5.	Would conformity of Uniform System with generally accepted principles be improvement?	
a)	Yes.	79%
b)	No.	17%
c)	Not certain.	4%
6.	Will Commission prescribe in the near future: (Yes)	
a)	depreciation accounting for track components?	38%
b)	deferred income tax accounting?	8%
c)	both of these?	21%
d)	neither of these?	25%
	no response.	8%
7.	How important, to railroads, is improvement in reporting?	
a)	very important.	8%
b)	equal in importance to solution of other problems.	25%
c)	less important than (b).	42%
d)	insignificant relative to (b).	17%
	no response.	8%

the effort that would be involved in implementing the former could be fantastic, a possible tax advantage through double deduction could result from its implementation. The implementation of the latter, given current economic conditions, would have an adverse effect on railroad reported income. The respondents, therefore, appear to be expressing what they would accept from the Commission rather than what might be prescribed. However, since the Commission generally responds to the justified wishes of the regulated firms, the railroads are more likely to get what they want than what they do not want. It appears, from the analysis presented in Chapter III,³⁹ that neither depreciation accounting for track components nor tax allocation are being currently considered by the Commission for foreseeable implementation.

On the question as to whether the Uniform System is as applicable to internal accounting as it is to external reporting, 75 per cent of the respondents indicated that they found it necessary to develop an internal accounting system for managerial decision-making purposes. There were only 13 per cent that found the Uniform System adequate for both purposes, while 4 per cent could find no acceptable alternative and 4 per cent did not respond to the question.

³⁹ See Chapter III, sections entitled "Accounting for Federal Income Taxes" and "Betterment Accounting."

The principal weakness of the Uniform System of Accounts, . . . , is that it is virtually impossible to obtain reliable cost data from the Uniform System. This is because the System is keyed to the aggregate system costs, rather than to the costs of a specific service.⁴⁰

The response to the questionnaire bears out Ziebarth's comment. In fact, the Interstate Commerce Commission recognizes this limitation and encourages the companies to develop an effective internal accounting system and to seek assistance from certified public accountants as well as the Association of American Railroads.⁴¹

System of Financial Reporting

The two concepts that together determine which system of accounting better presents financial position and the results of operations of any company appear to be relevance and comparability. If certain principles of accounting are not relevant to the recording and reporting of the significant economic events facing a particular firm, they should not be used as the results of their application could be misleading to users of these results.

If it may be assumed that the purpose of published financial statements is to allow an interested outside party to assess the financial position and results of operations

⁴⁰Letter from Karl Ziebarth.

⁴¹From an interview, January 29, 1968, with Richard J. Ferris, Assistant Director, Bureau of Accounts, Interstate Commerce Commission.

of a firm, a recent article by John K. Simmons⁴² becomes relevant to this discussion. Simmons makes a strong case for comparability being the only relevant use of published financial data. According to Simmons, an abstraction of the economic position of any company is highly subjective and likely to be misleading. As a result, an assessment of the relative economic position of two or more companies is likely to be made by comparing directly the various economic circumstances of one company with those of other companies. This is why a concept of comparability is important. In order for these comparisons to be meaningful in the determination of relative economic position, the economic circumstances must be reflected on an equivalent basis among the companies being compared. Simmons considers any item reported separately on the financial statements as a reported economic circumstance. Since accountants prepare the financial statements, it is a function of accounting to determine whether any two items should be considered as being similar or different economic circumstances. In order for comparability to be maximized, the following conditions must be satisfied by equivalent events being compared:

1. Equivalent statement presentation
 - a. Statement caption
 - b. Statement classification
 - c. Detailed information

⁴²John K. Simmons, "A Concept of Comparability in Financial Reporting," The Accounting Review, October 1967, pp. 680-692.

2. Equivalent measurement
 - a. Valuation basis
 - b. Measuring unit
 - c. Economic flow approximation.⁴³

Uniformity is the key to the equivalent statement presentation of any given economic circumstance by two or more companies. As it applies to accounting in connection with financial statement presentation, uniformity is the absence of variation in the statement presentation variables in the reflection of a given economic circumstance by two or more companies. It does not imply that all companies must have identical economic circumstances or that different circumstances should receive identical accounting treatment. Under the equivalent measurement caption, uniformity is again the key as far as the valuation basis and the measuring unit to be employed are concerned. Economic flows applicable to a given (the same) economic circumstance, however, may differ markedly between two companies. Equivalent measurement and reflection of a given economic circumstance, in such a situation, would require nonuniform approximation procedures, procedures appropriate to the underlying flows of the respective companies. If the economic flow pattern is similar for two companies in respect to a given economic circumstance, a uniform method would be necessary for equivalent approximation. If the pattern differs between the two companies, uniformity in the method of approximation could

⁴³Ibid., p. 683.

not possibly produce comparability. Uniformity in the statement presentation variables (caption, classifications, and detailed information), as well as the valuation basis and the measuring unit, is typically necessary to produce comparability in the reporting of a given economic circumstance. Uniformity in accounting approximation methods, however, produces comparability only where the economic flow being approximated is similar for both companies.

The practical difficulty of most significance relates to the measurement of these economic flow patterns. If it were possible to accurately measure the flows, then a uniform accounting method could be assigned to each flow. If there were perfect markets in reality, then it could be expected that economic flows for a given economic circumstance would be the same among firms in a given industry. On this basis, uniform accounting methods could be prescribed which would, when consistently applied, yield comparable financial information for each firm within an industry. Since, at least in general, imperfect labor, capital and information markets exist, the applicable economic flows arising from a given economic circumstance may affect the firms within an industry in varying manners, justifying alternative approximation methods.

As indicated in Chapter II, the Uniform System has the capacity to accept variations.⁴⁴ The railroad company must submit evidence to the Interstate Commerce Commission that the financial position and/or the results of operations would be more properly presented before the Commission will consider approval of the departure from uniformity. In other words, factual evidence of the relevant economic flows pertinent to the subject under consideration determines the accounting practice to be followed. Because of the Commission's authoritative, but impartial, position, its prescribed practices may be considered to be more appropriate than those principles, considered to be generally accepted, selected by the management of a nonregulated firm.

Summary

Even though the Interstate Commerce Commission has allowed the railroads to apply generally accepted accounting principles as the basis for their reporting to others than the Commission since 1962, the majority continue to use, in substance, the Uniform System of Accounts for all financial statements. Of the 31 audited 1966 annual reports in the sample, 27 received qualified opinions and 23 of these were for lack of a provision for deferred federal income taxes. None of the financial statements were qualified for the use

⁴⁴See Chapter II, n. 38 and following.

of betterment accounting for track components. For 28 firms it was possible to approximate a reconciliation between net income stated on the two reporting bases. This reconciliation revealed that if net income were reported on the basis of generally accepted principles it would have been 18.7 per cent lower than if reported on the basis of the Uniform System. The sheer magnitude of this difference, as well as its direction, has served as a strong deterrent to generally accepted reporting. Hayden, Stone, Incorporated believes that rail earnings are quite reliably reported on the basis of the Uniform System and this conclusion is reinforced by the responses to the railroad questionnaire. If flow-through accounting for income taxes and betterment accounting for track components are relevant for railroad reporting, as are the corresponding generally accepted principles, perhaps it should be the responsibility of independent auditors to accept this fact.

CHAPTER V

THE AUDITOR AND RAILROAD FINANCIAL STATEMENTS

Introduction

The American Institute of Certified Public Accountants has established a definite view toward auditor responsibility related to railroad financial statements. This perspective has been developed over time and is reflected in auditing standards, Accounting Principles Board Opinions and the formation and activities of a Committee on Relations with the Interstate Commerce Commission. At one time, because their accounting was regulated, railroad financial statements were not considered to be subject to a comparison with generally accepted accounting principles in the audit opinion statement. This situation has been rectified but railroads are still considered somewhat apart from other types of business firms, as evidenced by the special Institute Committee.

There have been comments made, both from within and without the accounting profession, that the Institute's position should be reevaluated. This chapter develops the Institute view toward railroad financial statements, some

criticisms of this view, and proposes a more adequate philosophy of responsibility for the auditor and the profession.

History

Prior to 1957, it had been noted in the literature that railroad accounting differed from the accounting practiced by industrial companies. Two basic problems were recognized: multiple purpose use of data prepared primarily with one purpose in mind, and the role of the accounting profession relative to stating an opinion on financial statements based on a system other than generally accepted accounting principles. George O. May, one of the most prolific writers on railroad accounting, highlighted the regulatory purpose behind financial statements prepared from the Uniform System of Accounts and questioned the use of these statements for other purposes.¹ He also criticized the accounting profession for attempting to make these statements serve multiple purposes through the use of footnotes to the statements.

Criticisms have often been based on the fact that methods have differed, without regard to the question whether in a particular case the method followed was prejudiced to any legitimate interest. These criticisms have resulted

¹George O. May, "Improvement in Financial Accounting," Dickinson Lectures in Accounting (Cambridge, Massachusetts: Harvard University Press, 1943), p. 7.

in many footnotes to published statements-- footnotes not always lucid, and the gradual accumulation of which has undoubtedly tended to the confusion of stockholders and investors. Preoccupation with the importance of not misleading investors has obscured the desirability of enlightening them.²

May suggested that the role of the profession should be one of cooperation with regulatory agencies and the acceptance of a responsibility for the maintenance and wise development of accounting principles, at all times retaining independence not only from clients but also from the regulatory agencies.³ The accountant's obligation for the development of sound accounting principles was to the public, which included regulated firms.

It appears that this philosophy was paid only lip service until 1957, when the Committee on Relations with the Interstate Commerce Commission was formed. From 1957 to the present, this Committee has served as a mediation panel between the Institute and the Commission. Both parties can present problems for consideration by the other and this participative approach to problem solving has brought the two organizations much closer together. The profession has become more informed relative to railroad accounting and the Commission more fully understands the position of the

²Ibid., p. 36.

³George O. May, "Accounting and Regulation," The Journal of Accountancy, October 1943, p. 301.

certified public accountant. It is readily apparent that the Commission reacted positively to the formation of the Institute Committee by the number of immediate changes made to the Uniform System following the suggestions of the Committee.⁴

One example of abrogation of the concept of responsibility as presented by May was the practice of certified public accountants. Prior to 1961, auditors' opinions on railroad financial statements expressed conformity with the prescribed accounting principles and practices rather than conformity with generally accepted accounting principles. One exception is found in the audit opinions rendered on the financial statements of the Chicago and North Western Railway Company by Arthur Andersen & Co.⁵ Beginning with its first audit of the Company in 1956, Arthur Andersen & Co. compared the financial statements with generally accepted accounting principles and qualified its opinion because the Company followed betterment accounting for track components. In 1958, at the request of Leonard Spacek, then Managing Partner of Arthur Andersen & Co., the American Institute's Committee on Professional Ethics considered the question of whether public accountants' opinions with respect to the

⁴See Chapter II, n. 31 and following.

⁵See for example: 1956 Annual Report, Chicago and North Western Railway Company, p. 19.

financial statements of certain railroads were in violation of Article 2.02(e) of the AICPA Code of Professional Ethics, which states:

2.02 In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if . . .

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.⁶

The Committee on Professional Ethics concluded, after considering the question for eight months, that an auditor's opinion which states that the financial statements of a railroad are in conformity with accounting principles prescribed by the Interstate Commerce Commission, without making reference to generally accepted accounting principles, is not in conflict with the rule referred to above. The two principal reasons given by the Committee for this conclusion were as follows:

(1) There is a "strong presumption that the accounting prescribed by the ICC constitutes generally accepted accounting principles in that industry."

(2) "The Institute's Auditing Procedure Committee has not spoken specifically on the reports of railroads or other regulated companies. In the absence of some authoritative

⁶American Institute of Certified Public Accountants, By-Laws, Code of Professional Ethics, Numbered Opinions of the Committee on Professional Ethics, Objectives of the Institute Adopted by the Council (New York: American Institute of Certified Public Accountants, 1964), p. 30.

statement by the committee prescribing the reporting standards for what has been concluded is a special reporting problem, the validity of any reporting practice must rest on general use and general acceptance. The practice of reporting on railroad financial statements in terms of accounting principles prescribed or authorized by the Interstate Commerce Commission appears to be widespread."⁷

The Committee on Auditing Procedure disagreed and subsequently issued its opinion, stating in effect that generally accepted accounting principles are sufficiently broad to apply also to regulated companies and are therefore appropriate as a basis for the auditor's opinion. Material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this would require either a qualified or adverse opinion on such statements.⁸

Tax allocation.--Concurrently with the settlement of the auditor's position relative to published financial statements prepared according to the Uniform System of Accounts, the tax allocation issue was in the throes of change. When the Interstate Commerce Commission made its decision that

⁷Reprinted in: Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession (2nd ed.; Chicago: Arthur Andersen & Co., October 1962), pp. 119-120.

⁸Committee on Auditing Procedure, Qualifications and Disclaimers, Statements on Auditing Procedure, No. 32 (New York: American Institute of Certified Public Accountants, 1962), p. 72.

flow-through accounting would be followed by railroads,⁹ the Committee on Accounting Procedure of the American Institute of Certified Public Accountants was already on record as approving this action.

. . . where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations.¹⁰

The first Opinion issued by the new Accounting Principles Board in 1962 essentially affirmed the position taken by the Committee on Accounting Procedure, and extended the reasoning to cover the treatment of guideline depreciation also.¹¹ There were several dissents to this opinion, two of which referred to the special treatment accorded regulated industries.¹² The essential issue raised was whether reporting of annual income should be controlled by present or predicted practices dictated by Commissions, the Congress,

⁹See Chapter III, n. 16 and following.

¹⁰Committee on Accounting Procedure, Accounting Research Bulletin No. 44 (Revised) (New York: American Institute of Certified Public Accountants, July 1958), p. 3-A.

¹¹Accounting Principles Board, New Depreciation Guidelines and Rules, Opinion No. 1 (New York: American Institute of Certified Public Accountants, November 1962), p. 2.

¹²Arthur M. Cannon and Leonard Spacek dissented on this basis.

state legislatures, and the courts. The second Opinion rendered by the Board reaffirmed the position taken on allocation in its prior opinion and extended it to cover the treatment of the investment credit. The Board placed one qualification upon its disallowance of flow-through accounting, that exception being that if the application of flow-through accounting affects the rate-making process, it is an acceptable accounting practice for financial reporting. In other words, any prescribed accounting requirement which differs from generally accepted accounting principles, that affects the rate-making process, is acceptable for financial reporting.¹³ In Opinion No. 6, the Board removed the necessity for disclosure of the difference in net income generated but stated, in revision of Accounting Research Bulletin No. 44 (Revised):

9. When a company subject to rate-making processes adopts the declining-balance method of depreciation for income tax purposes but adopts other appropriate methods for financial accounting purposes, . . . , and does not give accounting recognition to deferred income taxes, disclosure should be made of this fact.¹⁴

¹³ Accounting Principles Board, Accounting for the Investment Credit, Opinion No. 2 (New York: American Institute of Certified Public Accountants, December 1962), p. 8, and in Addendum, p. 10.

¹⁴ Accounting Principles Board, Status of Accounting Research Bulletins, Opinion No. 6 (New York: American Institute of Certified Public Accountants, October 1965), p. 43.

Opinion No. 11, the application of which requires tax allocation rather than flow-through, does not apply to those "regulated industries in those circumstances where the standards described in . . . APB Opinion No. 2 are met. . . ." ¹⁵

The net result of this historical development indicates that the authoritative voices of the accounting profession have successively reaffirmed that firms, whose net income is used for rate-making purposes by regulatory agencies, may use flow-through accounting for financial statement presentation if it is presumed that the regulatory agency will apply its rate-making criteria consistently over time. The tenor of the arguments presented by the Committee on Professional Ethics, the Committee on Auditing Procedure, the Committee on Accounting Procedure, and currently, the Accounting Principles Board is that regulatory accounting designed for rate-making purposes is "generally accepted" accounting for the industry in which it is required.

The development, in Chapter II, of the rate-making process employed by the Interstate Commerce Commission indicates that the net income figure is relevant in the process but that rates are not necessarily reduced as net income rises. Rate setting and adjustment are based primarily on an equitable balance in the transportation industry. In

¹⁵ Accounting Principles Board, Accounting for Income Taxes, Opinion No. 11 (New York: American Institute of Certified Public Accountants, December 1967), p. 156.

other words, since billing rates are not adjusted by the regulatory authority in response to the level of income, the railroads are not excluded by the Accounting Principles Board from following tax allocation. Therefore, because tax allocation is a generally accepted accounting principle and independent auditors base their opinions on the application of these principles, railroads receive qualified opinions.

Betterment accounting.--The Committee on Relations with the Interstate Commerce Commission approved betterment accounting for track components as an acceptable practice in the railroad industry. One of the primary reasons for this acceptance was a lack of evidence indicating that depreciation-maintenance procedures provided more appropriate charges to income. By not qualifying their audit opinions for the use of betterment accounting, certified public accountants have accepted the Committee's opinion that this accounting practice is a generally accepted principle for the railroad industry.

This acceptance has been questioned by Arthur Andersen & Co. in a letter to the American Institute written September 17, 1963.¹⁶ The arguments against betterment accounting, however, are based upon previous Institute

¹⁶Arthur Andersen & Co., Letter to American Institute of Certified Public Accountants Requesting Reconsideration of Its Position Regarding Replacement Accounting in the Railroad Industry (Chicago: Arthur Andersen & Co., September 17, 1963).

statements on depreciation accounting. The Arthur Andersen & Co. letter essentially argues that betterment accounting is not in conformity with these previous statements of the Institute and, therefore, should not be considered a generally accepted principle of accounting.

The Institute has not commented on the Arthur Andersen & Co. letter so its current position on betterment accounting must be considered to be the position expressed by the Committee. In other words, betterment accounting is generally accepted for the railroad industry.

Criticisms from Within the Accounting Profession

One of the most vocal critics of the accounting profession has been Leonard Spacek, Chairman of Arthur Andersen & Co., who argues that general acceptance of accounting principles is not a justification for their application. Rather, it is the reasoning as to fairness and soundness that justifies the use of an accounting principle.¹⁷ He blames government involvement in accounting development on the failure of accountants to develop sound accounting principles.¹⁸ His dissent to Opinion No. 2 of the Accounting

¹⁷ Leonard Spacek, "A Report by a Critic of His Profession," a speech presented at the Sixth Annual Accounting Forum of Hayden, Stone, Incorporated, November 10, 1967.

¹⁸ Ibid.

Principles Board has already been reported in this chapter.¹⁹ His dissent to Opinion No. 4 follows similar lines in that he is opposed to an increase in the number of alternative practices accepted by the profession. This emphasis on minimizing alternative accounting practices is not apparently a pressure for uniformity, but rather an urging for comparability. Although he tends to use uniformity and comparability interchangeably, his plea is as follows:

As nearly as possible, only one accounting method should be used for fully comparable transactions. Since there are shades of difference in the circumstances of the many transactions, net income reported can have some range of variation--some difference in hue--even in similar situations. But the result must remain within the spectrum of the basic color.²⁰

Spacek criticizes the accounting profession for allowing general acceptance to inhibit the development of sound accounting principles which could be applicable to all industries whether regulated or not. He concludes that fair presentation of financial results is questionable when the basis upon which the principles are founded is as weak as general acceptance.

John L. Carey, Executive Director of the American Institute of Certified Public Accountants, suggests that the

¹⁹See n. 12 and following.

²⁰Leonard Spacek, "Comparability in Financial Reporting," The IAS Balance Sheet, 1, No. 3, International Accountants Society, Inc., Chicago, 1967, 2A.

wide-spread acceptance of the standard short form opinion, and the auditing standards and procedures on which it is based, may have a stultifying effect on the attitudes of public accountants. "May CPAs . . . be discouraged from venturing outside the conventional scope of the standard opinion by providing explanations and interpretations which would be helpful to readers of the statement?"²¹ Certified public accountants were asked in interviews whether the auditor should disclose the following items in his opinion, if not disclosed by the railroads in notes to the financial statements:

- 1) differences in philosophy between the Uniform System and generally accepted accounting principles,
- 2) dollar amounts not material in the current year but related to differences between the systems, and
- 3) a precise statement of the system of accounting used by the railroads.

The preponderance of opinion was that the auditor's responsibility toward disclosure relates only to material departures from generally accepted accounting principles (such as the absence of a provision for deferred taxes). Taking an exception in an audit opinion is a harsh act on the part of the auditor and is the best recourse open because an adverse opinion would be less valuable and more confusing to the

²¹John L. Carey, The CPA Plans for the Future (New York: American Institute of Certified Public Accountants, 1965), p. 191.

reader. Only under unusual circumstances does an auditor need to depart from the standard opinion.²² These exceptional circumstances do not include the expressed intent of a railroad company to report according to a system of accounting that is not generally accepted, since there is usually but one material variance and that can be handled by qualifying the standard opinion. The magnitude of the dollar value of the variance is of no consequence other than in determining materiality.

Eldon Hendriksen raises an issue which, in many ways, parallels the two previously raised when he states, in relation to the auditor's statement of opinion:

When accounting theory is further developed as an evaluation tool, the terms "logical" and "appropriate" should be substituted for "generally accepted." General acceptance does not make the methods logical or logically derived from accounting postulates and principles.²³

Hendriksen echoes the argument advanced by Spacek that general acceptance does not necessarily yield acceptable accounting principles. This quotation indicates that variations in methods of applying these accounting principles would be allowed where appropriate. "Generally accepted"

²²From interviews, January 24, 1968, October 24, 1967, and January 24, 1968, respectively, with James R. DePauw of Arthur Andersen & Co., Ernest J. Rua, Jr., of Peat, Marwick, Mitchell & Co., and Howard Dudley Murphy of Price Waterhouse & Co.

²³Eldon S. Hendriksen, Accounting Theory (Homewood Illinois: Richard D. Irwin, Inc., 1965), p. 464.

could imply mediocrity in the principles developed as differing views need to be somehow compromised. "Logical" and "appropriate," however, would conceivably free the auditor from the pressure of accepting only what is "generally accepted" and thereby improve financial reporting. At the same time, it would force the auditor to evaluate the appropriateness of the method being applied, which is not currently required.

Criticisms from Outside the
Accounting Profession

Karl Ziebarth, a financial analyst with Hayden, Stone, Incorporated, states that:

The auditor must, . . . , be sure to say or to specify in his letter [opinion] that the accounting system is kept under the rules of the ICC, and it varies widely in both concept and practice from the accounting principles used in industry generally.²⁴

In other words, since the accounting system used by railroad companies is prescribed by a regulatory agency, the accountant should be obligated to inform stockholders of the same. If a financial analyst would require such a disclosure, this information should be even more important to less sophisticated users of financial statements. John G. Kaptain, an analyst with Merrill Lynch, Pierce, Fenner & Smith, Inc., reinforces this requirement by stating that "the investing

²⁴Letter dated January 11, 1968.

public does not appear to recognize the distinction" between the two methods of accounting.²⁵ If investors do not understand that there is a difference, the reasons for the difference, and the extent of the difference--and the railroad companies do not disclose this information in footnotes to the financial statements--then these analysts feel that the auditor should. This is essentially the same argument raised previously by John L. Carey.

John Thackray presents an observation that strikes at the heart of the difference between the sophisticated and unsophisticated users of financial information. He notes that, to the outsider, the term "generally accepted accounting principles" seems clear enough, but the auditing profession well knows that these four innocuous-sounding words are, in fact, deceptive rather than illuminating.²⁶ He goes on to say:

[Accounting firms] are extremely sensitive on the question of accounting principles--for it strikes at the very heart of the only commodity that independent auditors have for sale: skill, judgment and integrity.²⁷

Thackray suggests that generally accepted accounting principles are neither as substantive nor as protective as the

²⁵Letter dated November 29, 1967.

²⁶John Thackray, "Civil War Among the Auditors," Duns Review, April 1964, p. 43.

²⁷Ibid.

unsophisticated reader might initially believe. They are man-made rules and only have assurative qualities because of the skill, judgment and integrity of the accounting profession. Should any of these three attributes become questioned by statement users, generally accepted accounting principles could lose any value they might have had. The substantive value of general acceptance was previously questioned by Leonard Spacek.

The chief financial officer of a Class I railroad, when interviewed, stated that the skill, judgment and integrity of the accounting profession is threatened by the nature of the principles being generated.²⁸ This doubt of the profession's quality is reflected in the confusion, rather than protection, of the investing public created by highly technical and incomplete bulletins. He cites, as an example, the provision in Accounting Principles Board Opinion No. 9 which states, in essence, that earnings per share, where convertible preferred stock is outstanding, must be reported on a fully-diluted basis.²⁹ The Opinion is inadequate as it does not require disclosure of the pertinent events that must take place before this dilution can occur. The earnings per share reported may therefore be misleading,

²⁸Interview January 23, 1968.

²⁹Accounting Principles Board, Reporting the Results of Operations, Opinion No. 9 (New York: American Institute of Certified Public Accountants, December, 1966), pp. 123-124, 137-138.

even to the sophisticated user of the financial statements if the probability of full dilution is very small. The information could also be misleading if the dilution were expected to occur but only in the distant future. The call features, if any, should also be disclosed. Reporting fully-diluted earnings per share may provide for better financial reporting, but users of the reported information must also understand the background and relevance of the modification or the figures are susceptible to misinterpretation.

Relevant Auditor Responsibility

A highly developed economy and free and active capital markets go hand in hand with a highly-respected and competent independent accounting profession.³⁰ Continued confidence in financial reporting and the profession is essential to our economy and neither unnecessary criticism of nor passive indifference by the profession should be allowed to erode this confidence.³¹ The Securities and Exchange Commission has stated flatly of the public accountant that "his duty is to safeguard the public interest, not that of his client. . . ."³²

³⁰James J. Mahon, "Accounting Principles Debate and Investor Confidence," Financial Executive, December 1966, p. 32.

³¹Ibid.

³²Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670-71 (1957).

The certified public accountant is required to attest to the fairness of presentation of information presented in the financial statements to which his opinion is directed. The guide to fair presentation which is required is conformity with "generally accepted accounting principles."³³ Some principles, of course, are required upon which to judge fair, as opposed to biased, presentation. But, there are serious doubts as to whether general acceptance yields acceptability with regard to accounting principles. Hendriksen indicates that perhaps general acceptance is a stop-gap measure to be used only until accounting theory is further developed as an evaluation tool, whereupon the words "logical" and "appropriate" will be adopted to better reflect the accountant's approval of the principles employed by his client.³⁴ On the surface, this sounds reasonable but the responsibility of the auditor is not adequately defined by this statement. If accounting principles are generally accepted and fair presentation implies only conformity with these principles, then the auditor need not exercise professional judgment--indeed he need not even be a professional.

³³Committee on Auditing Procedure, Auditing Standards and Procedures, Statements on Auditing Procedure, No. 33 (New York: American Institute of Certified Public Accountants, 1963), p. 16.

³⁴See n. 22 and following.

If, however, the accountant is not ham-strung with "general acceptance" and must evaluate the practices employed by management in terms of the fairness of presentation derived from their use, professional judgment is indeed required. If the "relevance" standard, advanced by the American Accounting Association Committee, for reported data may be extended to the principles by means of which the data are accumulated, this point may be clarified.

Relevance is the primary standard and requires that the information must bear upon or be usefully associated with actions it is designed to facilitate or results desired to be produced. Known or assumed informational needs of potential users are of paramount importance in applying this standard.³⁵

If relevance may be considered as the primary standard for information, may it not also be considered the primary standard for judging the principles under which the information is developed for financial reporting.

The challenge to produce sound, unbiased accounting today is directed to the public accountant. The challenge is whether the public accountant has the will and the integrity to report the facts--economic realities--to all segments of the public in a truthful and meaningful manner.³⁶

³⁵Committee to Prepare a Statement of Basic Accounting Theory, A Statement of Basic Accounting Theory (Evanston, Illinois: American Accounting Association, 1966), p. 7.

³⁶Leonard Spacek, "A Report by a Critic of His Profession."

The import of all this is that one portion of auditor responsibility is the exercise of professional judgment in the determination as to whether the principles applied by a client firm are logical or appropriate, i.e., relevant, to the data being presented. It is not acceptable for the certified public accountant to look only to what other public accountants are accepting; he should make his own independent appraisal and his audit opinion should reflect the exercise of professional judgment.

If the public accountant possesses the analytical ability to determine the economic facts and at the same time has the fortitude and integrity to report impartially what he finds, he will perform that service which has been assigned to him by all segments of the public.³⁷

The other aspect of auditor responsibility has to do with the development of guidelines to fairness of presentation. It is no longer possible to say that fairness is produced by the application of generally accepted accounting principles for two reasons. First, the principle that general acceptance produces acceptable accounting principles has been questioned. Second, careful analysis will show that this reasoning is circular: fair presentation is the application of generally accepted accounting principles. Generally accepted accounting principles are those developed to yield fair presentation. Fair presentation is not separately defined.

³⁷Ibid.

It is necessary to borrow another informational standard from the American Accounting Association Committee, that of "freedom from bias," in order to establish adequate guidelines to fairness.

Freedom from bias means that facts have been impartially determined and reported. It also means that techniques used in developing data should be free of built-in bias.³⁸

Fairness of presentation requires freedom from bias because of the many users accounting serves and the many uses to which accounting information may be put. This is especially true in published financial statements where current and potential investors, employees, creditors and labor interests, to name a few, have an interest in the data presented. The presence of bias which may serve the needs of one set of users cannot be assumed to aid or even leave unharmed the interests of others. In order for financial statements to be fairly presented, there must be freedom from intentional or statistical partiality if at all possible.

The two elements of auditor responsibility described above make it essential that the auditor step beyond the confines of the standard audit opinion and the related standards on each audit examination. Not only must the auditor evaluate the accounting principles applied by the client firm, but his responsibility should extend to ability to

³⁸Committee to Prepare a Statement of Basic Accounting Theory.

justify the reasoning upon which his opinion rests. He no longer should be allowed to hide behind the shield of generally accepted accounting principles but should be required to be able to justify his opinion. This would result in a more professional standing for the profession because logical reasoning substantiated by factual evidence would be the basis upon which the accountant's opinion would rest.

This concept of auditor responsibility, if accepted by the profession would also improve comparability between the financial statements of different companies. The concept of fairness would remove intentional bias and the concept of relevance would represent a concerted attempt to properly recognize the pertinent economic flows in each enterprise. The concept of comparability advanced by John K. Simmons would become more of a reality than exists at the present time.³⁹

The discussions in Chapter III relative to flow-through accounting for federal income taxes and betterment accounting, as practiced by the railroads, has shown them to be reasonable alternatives to the generally accepted treatments followed by the accounting profession. Flow-through accounting for federal income taxes has resulted in a presentation of net income similar to that which would

³⁹See Chapter IV, n. 42 and following.

have been obtained had partial allocation been prescribed by the Commission. Partial allocation was considered in this thesis to be consistent with current accrual accounting and representative of the economic realities facing the railroads. Betterment accounting was considered as relevant as depreciation accounting for track components because of the stable physical quantity of the asset and the nonmaterial effects of the change-over experienced by the Canadian railroads.

The American Institute nearly applied the concept of responsibility recommended herein in its acceptance of betterment accounting for railroad track components. Based upon the Canadian conversion experience, the Institute appears to have made the correct decision--to allow betterment accounting--but not based upon factual evidence that betterment accounting was at least equally as applicable as depreciation accounting. The closest the Institute came to exercising this type of reasoning was the acceptance of this accounting practice on the basis that depreciation accounting was not known to be more proper under the circumstances.

Summary

The American Institute of Certified Public Accountants has established the guidelines for the profession but these have been based upon general acceptance, which is at least questionable. If railroad accounting practices

prescribed by the Interstate Commerce Commission served only the purpose of rate regulation, this accounting would be considered by the Accounting Principles Board to be generally accepted. Since other purposes for the prescribed accounting also exist, railroad financial statements prepared on this basis are not considered by the Board to fairly present the financial position and results of operations of these companies. Considering fairness of presentation to be exemplified by freedom from bias and using the concept of relevance as the basis upon which accounting principles are to be judged, railroad financial statements represent a fair presentation even though generally accepted accounting principles are not applied.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

Introduction

The Hepburn Act of 1906 gave a fledgling governmental Commission the authority to prescribe uniform accounting principles for the then dominant mode of surface transportation in the United States. The primary purpose to be served by the "Accounting Classifications for Steam Railroads" was rate regulation. It was felt that rate regulation was necessary to eliminate the abuses of speculative railroad building, irresponsible financial manipulation, fluctuating and discriminating rate adjustments, and the overreaching exercise of monopoly power which existed in the railroad industry. An accounting system, now known as the "Uniform System of Accounts for Railroad Companies," was developed by the Commission, in conjunction with industry accounting personnel, from the most acceptable of the accepted accounting principles in use in the industry.

The growth in the public accounting profession, and its mid-twentieth century emergent interest in the railroads, brought about immediate and substantial changes in railroad accounting principles. The American Institute of Accountants, in 1956, established a Committee on Relations with

the Interstate Commerce Commission which may be given much of the credit for these modifications. It was a petition brought by one of the firms in this developing accounting profession that resulted in the ruling by the Commission allowing railroad companies the option to report to stockholders according to "generally accepted accounting principles." The railroads had remained publicly quiet during these petition proceedings and, in general, rejected the option. Even in their 1966 annual reports, they predominantly reported their financial position and results of operations in accordance with the prescribed accounting of the Commission.

The accounting profession began to base its statement of opinion for railroad annual reports on the application of generally accepted accounting principles in 1962, since the Commission had ruled that these principles were acceptable for financial reporting to stockholders. One accounting firm qualified its opinions on railroad statements for the practice of betterment accounting in lieu of depreciation accounting for track components. This reason for qualification created an inconsistency within the public accounting profession because the other firms had accepted the opinion of the Institute Committee in 1957 that betterment accounting was a generally accepted principle of accounting in the railroad industry. Since tax allocation was generally accepted by the accounting profession,

substantially all railroad annual reports began to be qualified for not applying this principle. In 1958, the Commission had ruled against tax allocation for reporting to the Commission, on the basis of arguments presented by the regulated companies and its own judgment, and the railroads generally reported according to the prescribed accounting in their annual reports to stockholders.

The Study and the Conclusions

This divergence in practice raises questions significant to contemporary accountants. The answers to some of these questions were seen to be the goals of this thesis.

Why, since the Commission allows it, do the railroads refuse to base their annual reporting to stockholders on generally accepted accounting principles and instead consistently follow the Uniform System of Accounts through which action they acquire qualified audit opinions on their financial statements? There are at least three reasons why the railroads have not conformed their annual reporting to generally accepted accounting principles. The first relates to the concept of fair presentation. Of the railroad companies surveyed, only 8 per cent based their financial reporting on generally accepted accounting principles while 96 per cent felt that their annual reports achieved the goal of fair presentation. If the railroads believe that fair presentation is achieved through application of the Uniform System, there is little incentive to make the conversion.

The second reason relates to the extent and effect of the difference between the financial results presented under the two bases of reporting. For twenty-eight railroads it was found that 1966 net income would be reduced 18.7 per cent if restated to conform with generally accepted accounting principles. Since it appears that investors do not fully comprehend the difference between the two systems of accounting and reporting on the basis of generally accepted principles would require the disclosure of two net income figures, there is even less incentive to change the basis upon which financial reporting rests. The third consideration is the acceptance, by financial analysts, of reporting according to the Uniform System. Financial analysts prefer the Uniform System because it is geared to railroads, it produces more comparability, and it has led to the presentation of more detailed data than would generally accepted accounting principles. Thus, the railroads have little incentive to prepare their annual reports to stockholders in accordance with generally accepted accounting principles.

Do the railroads have any theoretical or practical justification for applying betterment accounting in lieu of depreciation accounting for track components and flow-through accounting for federal income taxes in lieu of tax allocation if such principles are not generally accepted for other types of businesses?

The Committee on Relations with the Interstate Commerce Commission approved betterment accounting for the railroads on the basis that no evidence existed establishing depreciation accounting as more acceptable. Factual evidence was presented by two Canadian railroads that experienced conversion from betterment to depreciation accounting which indicated that neither the asset account balances nor the annual charges to income are materially different between the two asset accounting principles when applied to mature firms. This is practical justification for continuing to use a principle which has been consistently applied for nearly a century.

The Accounting Principles Board requires comprehensive deferral for federal income taxes, an ultraconservative principle based upon a going concern concept under which the total tax on pretax accounting income will equal the total tax on taxable income over the life of the firm. Although comprehensive deferral is based upon a liability concept, little consideration is given to the possible payment of this liability created. In this writer's opinion a more valid conception of tax deferral would be to base the liability on the significant probability of aggregate reversal of tax deductibility, i.e., the liability would reflect the amount of these deferred taxes that would become payable in the predictable future. This approach, "partial allocation," yields no allocation (flow-through) when aggregate reversal

(actual payment) is highly improbable. The Interstate Commerce Commission ruled in favor of flow-through accounting in 1958 on the basis of the speculative nature of any future liability. The Commission is prepared to re-evaluate its position on accounting for federal income taxes should an aggregate reversal become more probable, i.e., a liability is necessary for future income taxes when there is an expectation that payment will be required. Since no aggregate reversal has taken place and there is no significant probability of reversal in the immediate future, there is both theoretical and practical support for the position taken by the Commission and the railroads.

If there is theoretical and/or practical support for betterment accounting and flow-through accounting as practiced by the railroad companies, why do certified public accountants qualify their audit opinions on the financial statements of these firms? As was indicated previously, betterment accounting is considered by certified public accountants to be generally accepted in the railroad industry and a qualification is not given for the application of this principle. The use of flow-through accounting for federal income taxes, however, does garner a qualified opinion for the financial statements because certified public accountants do not consider this principle to be generally accepted. The independent auditor attests to fairness of presentation and uses, as his guide, generally

accepted accounting principles. The belief that the uniform application of generally accepted accounting principles to all firms in all industries inevitably results in fair presentation has previously been questioned. Railroads should not receive qualified opinions on their financial statements for the application of flow-through accounting if this principle best approximates the appropriate economic flows. Rather than rely on Opinions of the Accounting Principles Board, and other elements of general acceptance, as the acceptability test for accounting principles, the independent auditor should evaluate the underlying economic flows in the industry or firm in order to decide whether the principles applied by the client firm are appropriate. The basis of the auditor's opinion on financial statements should be the application of relevant accounting principles which can be expected to produce a fair presentation.

Two side issues, relevant to the quality of railroad accounting and annual reporting, were also examined. Would the application of generally accepted accounting principles yield more comparability among the companies in the railroad industry than does the application of the Uniform System? Does the Uniform System guarantee more uniformity in recording and reporting than would generally accepted accounting principles?

Comparability, uniform reporting of like economic events, is perhaps better achieved under a system of

prescribed accounting which emphasizes this concept. The application of generally accepted accounting principles allows relatively more alternative treatments than does the application of a uniform system, these alternatives being at the option of management. The Uniform System provides for relatively more uniform treatment because alternatives are granted by the Commission only upon submission of evidence indicating that an alternative practice would more adequately present the economic realities behind the financial position and results of operations of the requesting firm. Financial reporting on the basis of economic flows may yield more comparability than financial reporting based upon principles of accounting selected by management from among those generally accepted. From the above, it would appear that the Uniform System would guarantee more uniformity in recording and reporting than would generally accepted accounting principles. But the current trend in the accounting profession is toward greater uniformity. Accounting Principles Board Opinions have tended to prescribe uniform accounting principles without allowing for alternatives even if the prescribed principles are not applicable to individual firms. While the Interstate Commerce Commission tends to stress comparability, the Accounting Principles Board appears to be emphasizing uniformity.

Another portion of the thesis studied the position of the Commission in relation to the railroads, which is

almost that of an industry board of directors. Rather than being primarily restrictive, the Commission's emphasis has evolved into one of fostering the transportation industry. This philosophy was supported in Part C of the railroad questionnaire where 50 per cent of the respondents predicted a growing industry under continued regulation while only 13 per cent stated that the industry would decline. When asked whether or not uniform accounting appeared to them necessary for effective regulation, 71 per cent indicated that it was necessary. These responses, in conjunction with responses to other questions, indicate a general feeling of acceptance on the part of railroad financial executives as to the extent and focus of Commission regulation of the railroad industry.

The Impasse

This thesis has delved into what were considered the most important immediate issues regarding railroad financial reporting and auditor responsibility and a solution was proposed. Certain underlying and long-term issues were briefly disclosed that will need continuing future evaluation.

The accounting profession, very young relative to other professions, is in conflict with an old and well established agency of the government. Since 1957, the profession has certainly been successful in its endeavors to reform the accounting practices prescribed by the Commission as there

are but two significant variations remaining between the Uniform System of Accounts and generally accepted accounting principles. One of these differences is considered material enough to warrant a qualified audit opinion on railroad financial statements.

Qualification of the auditor's opinion appears to have had a minimal effect, if any, on the railroads involved, even though the accounting profession feels that this is a harsh act on its part. The railroad industry would probably appreciate a clean opinion but is unwilling to modify its financial presentation to remove the variances with generally accepted accounting principles. Railroad industry officials are not convinced that such qualified audit opinions have injured their position in the capital markets. As one industry official confided in an interview on January 23, 1968:

Sophisticated financial analysts recognize the auditing firm's qualification for deferred taxes in the proper light: the statements fail to conform to generally accepted accounting principles in this respect. The sophisticated analyst discounts this type of qualification as he has the figures available to make the adjustment should he choose to do so.

It is practically certain that the uninformed investor does not understand the tax allocation issue. To this person, the assurance provided by an auditor's signature may outweigh any words used by the auditor. The informed investor, who would be disturbed by what the auditor says, realizes that the information necessary to recast the financial

statements to the basis of generally accepted accounting principles is generally available in the footnotes and therefore disregards the qualification. The railroad industry appears to attempt to conform its financial reporting closely to generally accepted accounting principles in order to avoid qualifications on issues other than tax allocation as the majority of qualifications are for that purpose only.

The Securities and Exchange Commission.--The Securities Act of 1933 specifically exempts railroad securities from the jurisdiction of the Securities and Exchange Commission, which was established for stockholder protection. In a letter dated December 12, 1967, Lindsey J. Millard, Associate Chief Accountant of the Securities and Exchange Commission, stated that growth in the number of audited railroads, the use of generally accepted accounting principles in the financial reporting of some railroads, and railroad holding company activity which requires audited financial statements has resulted in "a trend toward better financial reporting by railroads." Millard speaks for a commission which has preferred to indirectly exercise its influence over financial reporting by supporting the accounting profession. In this letter, Millard pointed to the Securities Act of 1933 and the Securities Exchange Act of 1934 as the reasons why the Commission has not and will not become involved in the railroad annual reporting issue. It is not that the Commission would not like to have jurisdiction over railroad

securities. In the case of *Allegheny Corp. v. Breswick & Co.* [353 U.S. 151 (1957) and 355 U.S. 415 (1958)], the Interstate Commerce Commission and the Securities and Exchange Commission had agreed that the latter had jurisdiction over the subject securities. But the courts disagreed and awarded jurisdiction to the Interstate Commerce Commission. If any responsibility for the protection of railroad security holders exists, it must rest with the Interstate Commerce Commission. This Commission's responsibility may be found in Section 20(a) of the Interstate Commerce Act where the phrase "compatible with the public interest" is repeatedly used in describing the accounting responsibilities of the Commission. But a study of the Act and the regulations enforcing the act does not disclose any detailed regulations designed to protect shareholders.

The Securities and Exchange Commission requires independently audited financial statements from subject corporations and unqualified audit opinions. Independent auditors base their opinions upon fairness of presentation generated from the application of generally accepted accounting principles, which have been developed over time in a competitive atmosphere. Conversely, the Interstate Commerce Commission has a small, highly specialized audit staff which performs the specialized, transactional audit required by the Commission. One of the unaudited railroads in the 1966 sample, in a letter dated January 31, 1968, confided:

. . . Company does not have audits by certified public accountants because it feels that the periodic audits performed by the Interstate Commerce Commission, which are quite detailed, are sufficient for its and the public's protection.

Independent audits are not a substitute but may serve as added insurance to the Commission against major misstatements. The Commission, in conjunction with the railroads, has developed the accounting system required for reporting to it. This uniform system was originally developed in an essentially monopolistic setting for an exclusively regulatory purpose. The accounting required by the Commission has evolved into a system, accepted by financial analysts, which is considered by the regulator and the regulated to fairly present railroad financial and operating data. But, it differs from what the Securities and Exchange Commission requires of those subject to its control. Two powerful governmental agencies, one established to protect investor interests, are in disagreement over the system of accounting to be followed by those firms subject to their control and on the use and value of independent audits.

The New York Stock Exchange.--The New York Stock Exchange, through letters to listed railroads in 1962 and 1963 from Phillip L. West, Vice-President, encouraged the railroad industry to conform its annual reporting to the basis of generally accepted accounting principles. Since that time, however, no action has been taken either in the form of additional encouragement or in the form of negatively

sanctioning those railroads that refuse to conform. The Stock Exchange appears to be accepting what the Securities and Exchange Commission will accept, which happens to be what the Interstate Commerce Commission accepts. This action reduces any security which users of railroad financial data may imply to the fact of exchange listing. The Exchange has sanctions which could be employed but refuses to exercise these sanctions for three apparent reasons. One reason is the effect on its influence of reversing its stand on historically acceptable railroad reporting. The second is the disruptive effect on the economy, the railroad industry, and the Exchange that could come about should it massively delist those railroads refusing to conform. The third is that the sanctioning of nonconforming railroads would be acting counter to the Securities and Exchange Commission, the generally more dominant organization and a government agency as well, because of the Commission's requirement not to tamper with the accounting required of federally regulated firms. The listing requirements of the Exchange, therefore, are no comfort to any who might rely upon Exchange listing as an indication that generally accepted accounting is being followed.

The Commission and the railroads.--The Interstate Commerce Commission and the railroads express the view that application of the Uniform System of Accounts leads to annual reports which are fair presentations. Should public

priorities shift from that of rate regulation to capital acquisition, fair presentation would become a greater issue in the future. Although it has not to the present, railroad annual reporting according to the Uniform System could achieve sufficient public disfavor that the railroads would receive less advantageous treatment in the capital markets than they have enjoyed in the past. The railroads might then be forced to adopt generally accepted accounting principles for financial reporting to the public. It is conceivable that the Commission's stand on tax allocation could be proven to be incorrect by the passage of time. It would be quite embarrassing to this governmental agency to have to admit serious misstatement of railroad income and equity over a considerable period of time. It is conceivable that the railroads may someday restate the track accounts and begin to use depreciation accounting rather than betterment accounting. Such a restatement could evidence substantial asset and equity misstatements that might have accrued over time. It is also possible that such an asset restatement and change in accounting policy could have an effect on rates charged by the railroads because the capital turnovers are low and rate margins must be high in order to service capital. Such a rate increase, should it result, might indicate that the use of betterment accounting had led to the creation of a rate structure that did not sufficiently provide for capital maintenance. The effects on the railroad

industry, both in terms of the impacts on the financial statements and on the rate adjustments, if any, that would be required in order to maintain the level of current earnings, should be subjects of future inquiry. Asset, income, and equity misstatements from any source could adversely affect the railroads in the capital markets.

The trend in the economy toward more government control may be mitigated in the case of the railroads by the mature status of the industry and the intense competition developing in the transportation sector. Should the railroad industry become much less regulated, it could become subject to at least two pressures it presently does not face that could be affected by its system of financial reporting. Much less regulated, the railroads could be placed in more direct competition with industrial and other nonregulated concerns in the capital markets. Pressure could be brought to bear on the railroads by the capital markets to conform their reporting to the same system used by the other firms competing for funds. Another consequence of being less regulated could be the subjection of railroad securities to the rules of the Securities and Exchange Commission. This development could force all railroads to be independently audited and to report according to generally accepted accounting principles. In sum, it may be advantageous for the Commission and the railroads to seriously reconsider

their position in this impasse and the implications of maintaining the status quo.

The accounting profession.--The growth of the governmental sector of the economy could pose difficulties for the accounting profession. One of these is that the strength of the profession is being tested in a conflict with a regulatory agency over accounting principles. Its response to this situation may well establish the ability of the profession to deal with future conflicts with regulatory agencies. Another problem is that failure to resolve this impasse could foretell of future situations of this nature that could develop between the accounting profession and this growing governmental sector. Another difficulty may be created by a lack of resolution of the conflict between the profession and the Interstate Commerce Commission. A weak stand, or no stand, on the part of the profession could raise a question about the importance of the issues in dispute and perhaps of the importance of the opinion expressed by independent accountants on financial statements.

One major question facing the accounting profession is whether it is properly qualifying railroad annual reports. One guide defining a concept of relevant auditor responsibility was presented and discussed in Chapter V. But this approach could conceivably result in division within the accounting profession. Differing viewpoints as to circumstances, as well as differing circumstances, could yield

unqualified audit opinions for some railroads and qualified opinions for others. Currently auditors seem to follow uniform qualification procedures because in unity there is some strength. As an example, two of the largest certified public accounting firms, Haskins & Sells and Price Waterhouse & Co., dissented from Opinion No. 11 of the Accounting Principles Board. Their dissents both reflected a desire on the part of these firms to apply a concept of partial allocation in the reporting of federal income taxes. The application of such a concept of tax allocation could result in unqualified opinions being granted by the firms to railroad companies which they audit. But Russell D. Tipton, in a letter dated March 1, 1968, and Howard Dudley Murphy, in a letter dated February 16, 1968, both affirmed that though their firms disagreed with the decision of the Board, this decision would be followed by both firms. Misinterpretation of circumstances or an improper view toward the circumstances, under the suggested "relevance" approach, could lead to inconsistent auditor opinions and perhaps incorrect action taken by users of published railroad financial data. The accounting profession should seriously consider these implications.

Another major question facing the accounting profession relates to the power of the audit opinion qualified for lack of a deferred tax provision. Apparently, in the case of the railroads, this qualified audit opinion on financial

statements carries very little if any threat to the ability of the firm to operate and acquire needed capital. Although the Securities and Exchange Commission has no control over railroad financial reporting, informed users of reported data could press for conformity of the Uniform System with the requirements of this Commission. The fact that any such pressure has had no recent effect places the accounting profession in a somewhat weaker position relative to railroad audit opinions than it enjoys relative to other segments of the American economy. Because of SEC requirements, much of American industry is vitally affected by a qualified audit opinion on published financial statements. But the growing trends toward railroad involvement in holding company activity may permit the qualified audit opinion to begin to affect the railroads as the consolidated financial statements of the holding company are subject to the regulations of the Securities and Exchange Commission. For other railroads, the accounting profession may need to determine another method of showing displeasure toward railroad annual reporting since qualification is not appreciably effective. Short of governmental action, the Institute Committee on Relations with the Interstate Commerce Commission might act as the influence toward mitigating the need for qualification. Ernest J. Rua, Chairman of the Committee, stated, in an interview on October 24, 1967, that one of the primary functions of the Committee is to assist the Interstate Commerce Commission in

conforming the Uniform System with generally accepted accounting principles. But Rua suggests that movement toward such conformity would be facilitated by the support of financial analysts and investment bankers, who currently accept financial statements prepared on the basis of the Uniform System.

The accounting profession needs to reconsider its position in relation to maintenance of the status quo. Non-action on the part of the profession would continue the impasse with the fairly predictable result that the qualified audit opinion on railroad financial statements would consistently lose value over time unless the Uniform System is brought into conformity with generally accepted accounting principles or the profession's stand on tax allocation is revised so as to exclude railroad financial statements from qualification. As indicated, financial analysts, the Securities and Exchange Commission, and the New York Stock Exchange accept the Uniform System for financial reporting so the accounting profession must press for change alone. Assuming that the Interstate Commerce Commission and the railroads remain adamant against change and the accounting profession is convinced that modification is desirable, a threat more powerful than qualification will need to be developed. Perhaps the most reasonable approach to be adopted by the profession would be to utilize the existing Institute Committee on Relations with the Interstate Commerce

Commission to effect some reconciliation. This Committee had astonishing success when first formed and has acted as a mediation panel since 1957. Perhaps a joint study by the Commission and the Committee of the principles of accounting that have led to the impasse could point the way to resolution of the conflict. The implications of the impasse on all parties and the effects of different approaches to reconciliation could be intensively studied. It is doubtful if any of the parties involved truly wish to be in conflict with the others. Through cooperation between the Institute Committee and the Interstate Commerce Commission, a solution equitable to all involved parties seems attainable.

APPENDIX A

SAMPLE OF CLASS I RAILROADS

LIST OF COMPANY NAMES

1. Atchison, Topeka & Santa Fe
 2. Atlantic Coast Line
 3. Baltimore & Ohio (included in Chesapeake & Ohio)
 4. Bangor & Aroostook
 5. Boston & Maine
 - *6. Canadian National
 - *7. Canadian Pacific
 8. Central of Georgia (included in Southern)
 9. Chesapeake & Ohio
 10. Chicago, Burlington & Quincy
 11. Chicago & Eastern Illinois
 12. Chicago Great Western
 13. Chicago, Milwaukee, St. Paul & Pacific
 14. Chicago & North Western
 15. Chicago, Rock Island & Pacific
 16. Delaware & Hudson
 17. Denver & Rio Grande Western
 18. Erie-Lackawanna
 19. Great Northern
 20. Gulf, Mobile & Ohio
 21. Illinois Central
 - ‡22. Kansas City Southern
 23. Lehigh Valley
 24. Louisville & Nashville
 25. Maine Central
 26. Missouri-Kansas-Texas
 27. Missouri Pacific
 28. Monon
 29. New York Central
 - †30. New York, New Haven & Hartford
-
- | | |
|-----------------------------|----------------------|
| 31. Norfolk Southern | 38. Soo Line |
| ‡32. Norfolk & Western | 39. Southern Pacific |
| 33. Northern Pacific | 40. Southern |
| 34. Pennsylvania | 41. Texas & Pacific |
| 35. Reading | 42. Union Pacific |
| 36. St. Louis-San Francisco | 43. Western Maryland |
| 37. Seaboard Air Line | 44. Western Pacific |

*Canadian companies, therefore not included in the sample.

‡Would not respond to request for financial statements, therefore not included in the sample.

†In trusteeship, therefore not included in the sample.

Coverage of the Class I railroads provided by the sample*

Number of Class I railroads for 1966	76	
Number represented in the sample	39	
Per cent	51.3%	
Total operating revenues (Class I railroads)		
Total operating revenues in the sample	\$10,655,000,000	\$9,284,103,000
Per cent		87.1%
Net railway operating income (Class I railroads)		
Net railway operating income in the sample	\$ 1,046,000,000	\$1,008,133,000
Per cent		96.4%
Net income (Class I railroads)		
Net income in the sample	\$902,000,000	\$806,471,000
Per cent		89.4%

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*Class I railroad statistics from Yearbook of Railroad Facts (1967 edition; Washington, D.C.: Association of American Railroads, 1967), p. 7.

APPENDIX B

RAILROAD QUESTIONNAIRE

The ten question questionnaire reproduced herein was sent to the chief financial officers of thirty audited railroads in the sample. Twenty-four of the thirty responded (80 per cent). The thirty audited railroads were:

1. Atlantic Coast Line
2. Chesapeake & Ohio
3. Bangor & Aroostook
4. Boston & Maine
5. Chicago, Burlington & Quincy
6. Chicago & Eastern Illinois
7. Chicago Great Western
8. Chicago, Milwaukee, St. Paul & Pacific
9. Chicago & North Western
10. Chicago, Rock Island & Pacific
11. Delaware & Hudson
12. Denver & Rio Grande Western
13. Erie-Lackawanna
14. Great Northern
15. Gulf, Mobile & Ohio
16. Illinois Central
17. Louisville & Nashville
18. Missouri-Kansas-Texas
19. Missouri Pacific
20. Monon
21. New York Central
22. Norfolk Southern
23. Northern Pacific
24. Reading
25. St. Louis-San Francisco
26. Seaboard Air Line
27. Soo Line
28. Southern Pacific
29. Western Maryland
30. Western Pacific

February 5, 1968

Dear Sir:

In connection with my doctoral dissertation entitled "Railroad Financial Reporting and Auditor Responsibility," I have prepared the following questionnaire. I would appreciate it if you would complete it and return it to me in the enclosed envelope.

The form of the questionnaire lends it to rapid answering in that an "x" can be placed in the () following the answer preferred. There is also a section provided for comments and amplification of answers. Total time to complete the questionnaire should not exceed ten minutes.

This information will be kept confidential. The nature of my dissertation is such that I am working with aggregates and percentages. It would not only be unethical but also impractical to identify the responses of individual railroads.

I intend to provide a summary of the results of this questionnaire to each respondent and therefore would appreciate your co-operation.

Yours truly,

Phillip A. Jones, Sr.

RAILROAD QUESTIONNAIRE

A. System of Financial Reporting to Stockholders

1. Are your company's financial statements prepared in accordance with:
 - a) The Uniform System of Accounts for Railroad Companies? ()
 - b) "generally accepted accounting principles?" ()
 - c) a combination of the two systems? ()
2. Would you say that your 1966 Annual Report "fairly represented the financial position and results of operations" of your firm?
 - a) Yes. ()
 - b) No. ()
 - c) not certain. ()
3. "Generally accepted accounting principles" for financial reporting are:
 - a) superior to the Uniform System of Accounts. ()
 - b) equally as meaningful as the Uniform System of Accounts. ()
 - c) inferior to the Uniform System of Accounts. ()
 - d) not relevant to railroad financial reporting. ()
4. Do you feel that the Uniform System severely restricts managerial freedom in portraying the effects of economic events upon the firm?
 - a) Yes. ()
 - b) restricts, but not severely. ()
 - c) does not restrict. ()
5. Do you feel that the attempts of the Interstate Commerce Commission to conform the Uniform System to "generally accepted accounting principles" are leading to improvement in railroad financial reporting?
 - a) Yes. ()
 - b) No. ()
 - c) Not certain. ()
6. Do you feel that either of the following will be prescribed by the Interstate Commerce Commission in the foreseeable future?
 - a) depreciation accounting for track components. ()
 - b) deferred income tax accounting. ()
 - c) both of these. ()
 - d) neither of these. ()

7. How would you evaluate improvement in financial reporting practices relative to the other difficulties faced by the railroad industry?
- a) very important. ()
 - b) equal in importance. ()
 - c) of less significance. ()
 - d) insignificant. ()

B. System for Effective Managerial Information Gathering

Does the Uniform System of Accounts provide a mechanism whereby information for effective managerial action is readily available or was it necessary for you to develop your own internal accounting system for managerial decision making and analysis of internal operations?

- a) The Uniform System serves both external and internal reporting purposes adequately. ()
- b) The Uniform System is not adequate for internal accounting but we have found no acceptable alternative so continue to use it. ()
- c) The Uniform System is used for external reporting but we have developed an internal accounting system for managerial decision making purposes. ()

C. General

1. Considering the maturity of the industry, do you feel that it is necessary for railroads to have uniform accounting systems in order for effective regulation to be achieved?
 - a) Yes. ()
 - b) No. ()
 - c) not certain. ()
2. How would you assess the future of the American railroad industry under continued regulation?
 - a) a growing industry. ()
 - b) a stable industry. ()
 - c) a declining industry. ()

D. Comments

If there is any question which you feel needs a more amplified answer, please feel free to add your comments here. Thank you for your participation.

April 1, 1968

Dear Sir:

Attached is a summary of the questionnaire responses as I promised. I appreciate your cooperation in responding. The participation in this study was excellent. Out of 30 firms surveyed, 24 responded (80%) so the results are quite representative of the sample. Since these 30 roads were selected on the basis of size and investor interest, these results may be representative of the industry.

Thank you again for your participation.

Yours truly,

Phillip A. Jones, Sr.

SUMMARY OF RAILROAD QUESTIONNAIRE RESPONSES

A. System of Financial Reporting to Stockholders

1. Are your company's financial statements prepared in accordance with:
 - a) The Uniform System of Accounts for Railroad Companies? 29%
 - b) "generally accepted accounting principles?" 8%
 - c) a combination of the two systems? 63%

2. Would you say that your 1966 Annual Report "fairly represented the financial position and results of operations" of your firm?
 - a) Yes. 96%
 - b) No. ..
 - c) Not certain. ..
 - No response. 4%

3. "Generally accepted accounting principles" for financial reporting are:
 - a) superior to the Uniform System of Accounts. 42%
 - b) equally as meaningful as the Uniform System of Accounts. 32%
 - c) inferior to the Uniform System of Accounts. ..
 - d) not relevant to railroad financial reporting. 16%

4. Do you feel that the Uniform System severely restricts managerial freedom in portraying the effects of economic events upon the firm?
 - a) Yes. 21%
 - b) restricts, but not severely. 37%
 - c) does not restrict. 42%

5. Do you feel that the attempts of the Interstate Commerce Commission to conform the Uniform System to "generally accepted accounting principles" are leading to improvement in railroad financial reporting?
 - a) Yes. 79%
 - b) No. 17%
 - c) not certain. 4%

6. Do you feel that either of the following will be prescribed by the Interstate Commerce Commission in the foreseeable future?
 - a) depreciation accounting for track components. 38%
 - b) deferred income tax accounting. 8%
 - c) both of these. 21%
 - d) neither of these. 25%
 - no response. 8%



7. How would you evaluate improvement in financial reporting practices relative to the other difficulties faced by the railroad industry?
- | | |
|--------------------------|-----|
| a) very important. | 8% |
| b) equal in importance. | 25% |
| c) of less significance. | 42% |
| d) insignificant. | 17% |
| no response. | 8% |

B. System for Effective Managerial Information Gathering

Does the Uniform System of Accounts provide a mechanism whereby information for effective managerial action is readily available or was it necessary for you to develop your own internal accounting system for managerial decision making and analysis of internal operations?

- | | |
|---|-----|
| a) The Uniform System serves both external and internal reporting purposes adequately. | 13% |
| b) The Uniform System is not adequate for internal accounting but we have found no acceptable alternative so continue to use it. | 8% |
| c) The Uniform System is used for external reporting but we have developed an internal accounting system for managerial decision making purposes. | 75% |
| No response | 4% |

C. General

1. Considering the maturity of the industry, do you feel that it is necessary for railroads to have uniform accounting systems in order for effective regulation to be achieved?
- | | |
|-----------------|-----|
| a) Yes. | 71% |
| b) No. | 25% |
| c) not certain. | 4% |
2. How would you assess the future of the American railroad industry under continued regulation?
- | | |
|--------------------------|-----|
| a) a growing industry. | 50% |
| b) a stable industry. | 33% |
| c) a declining industry. | 13% |
| no response. | 4% |

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