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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Accounting Changes Needed In The Railroad Industry

In contrast to other industries, which use depreciation accounting for capital assests, railroads use a unique "betterment" accounting method for their track structure.

GAO believes the Interstate Commerce Commission and the Securities and Exchange Commission should require railroads to adopt depreciation accounting. This would enhance the comparability of railroads' financial reporting, assist the Congress in deliberations on regulatory reform and financial assistance to railroads, and provide better information to shippers and small investors.

Railroads also should include information on their maintenance and replacement practices, including deferred maintenance, in financial reports.

UNITED STATES GENERAL ACCOUNTING OFFICE

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses how a change in accounting method would improve the railroad industry's financial reporting and points out the need for readily available information on deferred maintenance. The report includes recommendations to the Interstate Commerce Commission and to the Securities and Exchange Commission to improve financial reporting by the railroad industry.

We initiated our review because of the importance of having reliable financial information about the railroad industry which is comparable to that being reported by other industries. Enactment of the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 demonstrates the continued congressional interest in improving the financial health of the railroad industry and its accounting practices.

We are sending copies of this report to the Director, Office of Management and Budget; the Chairman, Interstate Commerce Commission; the Chairman, Securities and Exchange Commission; and the Secretary of the Treasury.

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

ACCOUNTING CHANGES NEEDED IN THE RAILROAD INDUSTRY

D I G E S T

Railroads use retirement-replacement-betterment accounting (betterment accounting) to account for track structures. This unique accounting method applies only to railroads, and furthermore, only to the track structure. Other industries use ratable depreciation accounting (depreciation accounting) for capital assets. The choice of accounting method can significantly influence the reported cost of operations and the reported net income.

Depreciation accounting systematically and rationally allocates the cost of capital assets, such as buildings and machines, over their estimated useful lives. As a result, the cost of an asset is not charged entirely to the period when the item is purchased.

Betterment accounting is the method railroads are required to use to account for the track structure in reports to the Interstate Commerce Commission (ICC) and is generally used in reports to the Securities and Exchange Commission (SEC) and stockholders. Under betterment accounting, no systematic depreciation expense is taken. The cost of track structure replacements is charged to expense in the periods when the replacements occur. If a higher quality replacement is made, the portion of cost representing an improvement (betterment) is not charged to expense but is considered an asset.

ICC, because of its responsibilities for regulating the rail industry, including railroad accounting, and SEC, because of its authority to prescribe reporting rules and regulations for railroads, are concerned over the use of betterment accounting. Each has taken the initial step in the administrative process to change accounting and reporting rules. However, neither has proceeded beyond the Advance Notice of Proposed Rulemaking--SEC, because it is waiting for ICC to act; and ICC,

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because it has been waiting for the Federal income tax issue to be resolved. (See p. 16.)

DEPRECIATION ACCOUNTING SHOULD BE ADOPTED

Accounting is a system of measurement which provides quantitative financial information about an enterprise. Depreciation accounting is a more effective measurement technique than betterment accounting because it systematically allocates the cost of capital assets over their estimated useful lives, whereas betterment accounting does not.

The use of depreciation accounting would improve expense recognition and net income determinations, improve balance sheet presentations, and enhance comparability of financial information.

The principal benefit of comparability is that it is helpful in contrasting operating results between railroad and railroad, or between railroad and other industry. Thus it assists the Congress in deciding regulatory and subsidy questions, shippers in assessing rates, investors in making financial decisions, and the Federal agencies in exercising regulatory responsibilities. (See p. 10.)

CONCERN OVER TAX INCREASES SHOULD NOT PREVENT ADOPTING DEPRECIATION ACCOUNTING

Railroads' reported net income will probably be greater if they use depreciation accounting in reports to ICC and SEC. If railroads were required to use depreciation acounting for income tax purposes, their Federal income taxes would probably increase. But financial accounting and tax accounting are separate issues. However, in view of the possible consequences of an accounting change, the Congress and the Treasury offered proposals to mitigate the impact of higher taxes on the railroads. (See pp. 19-25.) The end result of the congressional interest in this matter was the enactment of Public Law 96-613 on December 28, 1980. Among other things, the new law prescribes betterment accounting as an acceptable method for Federal income tax purposes.

DEFERRED MAINTENANCE SHOULD BE REPORTED

Thousands of miles of track structures are in poor condition because the railroads have not performed maintenance. It has been suggested that a relationship exists between deferred maintenance and railroads' accounting practices. The implication is that if the railroads had used depreciation accounting, deferred maintenance would not have become a problem. GAO does not agree. (See p. 26.)

The effects of certain accounting methods on financial reporting could conceivably influence management decisions. However, GAO doubts whether use of a particular accounting method is the driving force behind decisions to spend money to maintain the track structure or to defer maintenance. Other factors such as a lack of cash or future plans for a line enter into these decisions.

ICC has required Class I railroads to report deferred maintenance information since 1974. The railroads reported that about $1.3 billion in track structure maintenance had been deferred as of December 1978. SEC is also considering deferred maintenance reporting requirements for railroads. Although reports to ICC are available to the public, GAO believes deferred maintenance information would be more readily available if included in reports to SEC and annual reports to stockholders. (See p. 26-29.)

RECOMMENDATIONS

The Interstate Commerce Commission should:

--Complete the October 1978 Advance Notice of Proposed Rulemaking and adopt depreciation accounting for the track structure.

--Coordinate future changes in deferred maintenance reporting requirements with SEC to guard against conflicting requirements being placed on the railroad industry.

The Securities and Exchange Commission should:

--Complete the April 1977 Advance Notice of Proposed Rulemaking on railroad accounting by adopting depreciation accounting for the track structure.

--Complete the study of deferred maintenance reporting covered by the April 1977 Advance Notice of Proposed Rulemaking, and require railroads to report deferred maintenance information which fulfills SEC needs yet does not conflict with ICC requirements.

AGENCY COMMENTS

ICC agrees that adopting depreciation accounting would benefit financial statement users. However, ICC has been concerned that an accounting change would increase Federal income taxes and undermine the financial stability of even the healthiest railroads. ICC has been waiting for the tax issue to be resolved before further considering the adoption of depreciation accounting for the track structure. (See p. 35.)

SEC agrees that depreciation accounting is a more effective measurement technique than betterment accounting but is waiting for ICC to act before proceeding with its study--initiated in 1977--of the appropriateness of betterment accounting. SEC believes that to do otherwise could burden users of financial statements with two methods of reporting for fixed assets.

After ICC and SEC commented on GAO's recommendations, the Congress passed legislation which, among other things, requires the Internal Revenue Service to accept betterment accounting for income tax purposes. The bill was signed into law (Public Law 96-613) on December 28, 1980. Therefore the possibility of increased taxes resulting from conversion to depreciation accounting is no longer an issue, and no reason exists for railroads not to use betterment accounting for income tax purposes and depreciation accounting for financial reporting purposes. Many such variations exist between tax reporting and financial reporting. GAO therefore believes the recognized benefits of depreciation accounting for financial reporting purposes are so overriding as to justify immediate action requiring this accounting method for the track structure.

Both ICC and SEC agreed with GAO that railroads should be required to report deferred maintenance information. However, SEC is deferring action on any such reporting requirement until it can be coordinated with a proposal relating to track structure accounting.

Contents

ABBREVIATIONS

GAO	General Accounting Office
ICC	Interstate Commerce Commission
SEC	Securities and Exchange Commission

CHAPTER 1

INTRODUCTION

Railroads use retirement-replacement-betterment accounting (betterment accounting) to account for track structures. This unique accounting method applies only to railroads, and furthermore, only to track structures--rail, ties, ballast, other track material, and labor costs. Other industries (and railroads in other aspects) use ratable depreciation accounting (depreciation accounting) for capital assets. 1/

Railroads are required to use betterment accounting for the track structure in reporting to the Interstate Commerce Commission (ICC); however, they are allowed to use depreciation accounting in reports to others, provided that any differences from ICC requirements are disclosed. Five of the 41 Class I 2/ railroads have exercised this option and are using depreciation accounting for the track structure in reports to the Securities and Exchange Commission (SEC) and to stockholders.

The choice between betterment accounting and depreciation accounting for the track structure has been a controversial issue for more than 50 years. The controversy has remained because under theoretical conditions the two methods should achieve similar results; however, in actual usage they achieve different results--especially for individual years. In particular, the choice of betterment accounting or depreciation accounting can significantly influence the reported cost of operations and the reported net income from operations, both of which are considerable--amounting to $24.5 billion and $794 million, respectively, for Class I railroads during 1979. 3/

Accounting is essentially a system of measurement which provides quantitative financial information used in making economic decisions. Depreciation accounting is superior to

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1/The Department of the Treasury and the courts refer to retirement-replacement-betterment accounting as RRB accounting. Betterment accounting and depreciation accounting are discussed in more detail in chap. 2.

2/Railroads with annual operating revenues of $50 million or more.

3/Preliminary data included in "Yearbook of Railroad Facts, 1980 Edition."

betterment accounting as a measurement technique because it systematically and rationally allocates the cost of assets over their estimated useful lives.

In addition, the two Federal agencies that regulate railroads' financial reporting and accounting--the ICC and the SEC--are questioning the further use of betterment accounting.

METHODOLOGY, SCOPE, AND OBJECTIVES

We made our review primarily in Washington, D.C. We reviewed current laws and proposed legislation, congressional testimony, and agency reports and documents. We researched the history of track structure accounting from regulatory, taxation, and accounting perspectives. We interviewed officials of ICC, SEC, and the Department of the Treasury. We also interviewed representatives of the following groups: (1) the Association of American Railroads, (2) railroads that had adopted depreciation accounting in reporting to stockholders, (3) railroads that use betterment accounting in reporting to stockholders, and (4) financial analysts with experience in the rail industry. We reviewed written comments that industry representatives and other interested parties had submitted in response to ICC and SEC requests for information. To determine how depreciation accounting would have affected railroads' reported net income for individual years, we selected 10 Class I railroads that had the highest revenue from railroad operations in 1977 and use betterment accounting in reports to stockholders. 1/ We restated their reported net incomes for 3 years using depreciation accounting. The underlying assumptions and methodology used in making these restatements are explained in appendix I.

Our review was restricted essentially to Class I railroads because of their predominance in the industry. Excluding the National Rail Passenger Corporation (AMTRAK), the 41 Class I railroads during 1978 accounted for 98 percent of the industry's traffic, and operated 94 percent of the rail mileage. Class I railroads reported track structure assets totaling $16.9 billion as of December 1978, which represented 43 percent of their assets.

We reviewed the issue of track structure accounting and financial reporting practices because the railroads' financial matters will play an ever more important part in the

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1/Excluding one railroad controlled by another Class I railroad.

debate that is now going on in the Congress, within the railroad industry, and among shippers and investors--a debate concerning financial assistance and the need for regulation of the railroad industry. A basic understanding of the major differences between betterment accounting and depreciation accounting is necessary to appreciate the differing effects the methods have on financial information.

CHAPTER 2

BETTERMENT AND DEPRECIATION AS ACCOUNTING METHODS

Accounting is essentially a system of measurement which communicates financial information about individual enterprises. All of industry employs the measurement technique of depreciation accounting, as do the railroads for all capital assets except the track structure. Railroads employ betterment accounting, unique to them and uniquely for the track structure. The procedural differences between betterment accounting and depreciation accounting, the resulting differences in reported net income, and the use of betterment accounting by only one industry have made track structure accounting a controversial subject for over 50 years. Although betterment accounting may have been proper years ago, changes in the railroad industry and in its economic environment make depreciation accounting superior to betterment accounting as a measurement technique.

WHAT IS DEPRECIATION ACCOUNTING?

Depreciation accounting is an accounting method that systematically and rationally allocates the cost of capital assets, such as buildings and machines, over their estimated useful lives. As a result, the cost of an asset is not charged entirely to the period when the cost is incurred, but allocated over the estimated useful life of the asset.

The estimated useful life of an asset, which determines how the costs are allocated, considers both physical and economic factors. Physical life considers how long an asset can be used or how many units it can produce. Economic life deals with the changing market conditions and expectations for use of the asset. Neither the physical nor economic life of most assets can always be accurately estimated. The goal is to make the best estimate of the physical or economic life, whichever is shorter, and depreciate the asset on that basis.

Depreciation accounting includes numerous methods, but they all follow the concept of systematic and rational cost allocation. Two of the most commonly used methods are straight-line and units-of-production. Under straight-line depreciation, equal portions of the depreciable cost are expensed each period throughout the estimated useful life of the asset. For example, if a business invested $10,000 in a new machine with an estimated useful life of 10 years and no salvage value, depreciation expense would be $1,000 ($10,000 ÷ 10 years) each year for 10 years.

Under units-of-production depreciation, the depreciation expense for a period is based on the percentage of the asset's estimated productive capacity consumed during the period. For instance, if the machine in the previous example had an estimated capacity of 100,000 units, depreciation expense of 10 cents ($10,000 ÷ 100,000 units) would be reported for each unit produced. If the machine produced 20,000 units in a year, depreciation expense would be $2,000 (10 cents x 20,000 units) for that year.

WHAT IS BETTERMENT ACCOUNTING?

Betterment accounting is the method railroads are required to use to account for the track structure in reports to ICC, and is generally used for reports to the SEC and stockholders. The original cost of the track structure, including labor and material costs, is capitalized, i.e., added to the asset account, and no systematic depreciation expense is taken. The cost of subsequent replacements of track structure material of equal quality is charged to expense in the periods when the replacements occur. Labor costs to make such replacements are also expensed.

"Betterments" occur when track structure materials are replaced by superior quality assets which make the track more useful, efficient, or durable. The added cost of the new superior material over the current cost of the material removed is capitalized and is therefore considered an asset. Also, the accounting for the betterment considers only the cost of the material. Labor costs are included in operating expenses of the period when the replacement occurs.

Under betterment accounting, track structure that is retired is written off as an expense in the year that the retirement occurs. The amount that is expensed is the capitalized amount; i.e., the amount carried on the "books" for that particular track structure.

The following examples demonstrate the accounting treatment of track structure replacements with and without a betterment. 1/ If a 115-pound rail line was originally installed in 1950 at a cost of $2 million ($500,000 for rail and $1.5 million for all other costs including labor), it would be capitalized and reported on the balance sheet as a cost of $2 million with no charge for track structure expense. If the line

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1/Since the purpose of the examples is to demonstrate the concept, they have been kept simple and do not include such things as salvage value and retirements.

was replaced in 1980 with equal quality assets, but at a cost of $3 million ($1 million for the 115-pound rail and $2 million for other costs including labor), the following would occur:

- --The investment in the line would remain on the balance sheet at the original cost of $2 million.

- --Track structure expenses for 1980 would be $3 million (the current cost of equal quality replacements including labor).

If the replacements in 1980 included 132-pound rail, rather than the existing 115-pound rail, the replacement would be considered a betterment since the heavier rail would allow increased loads over the line. Assume the quality of the other material (such as ties) was not improved and their cost in 1980 was the same as in the previous example ($2 million), but the cost of the rail increased from $1 million for 115-pound rail to $2 million for 132-pound rail, then the following would occur:

- --The balance sheet investment for the line would be increased from $2 million to $3 million (the $2 million cost capitalized for the line in 1950 plus the $1 million betterment portion of the rail replacement installed in 1980).

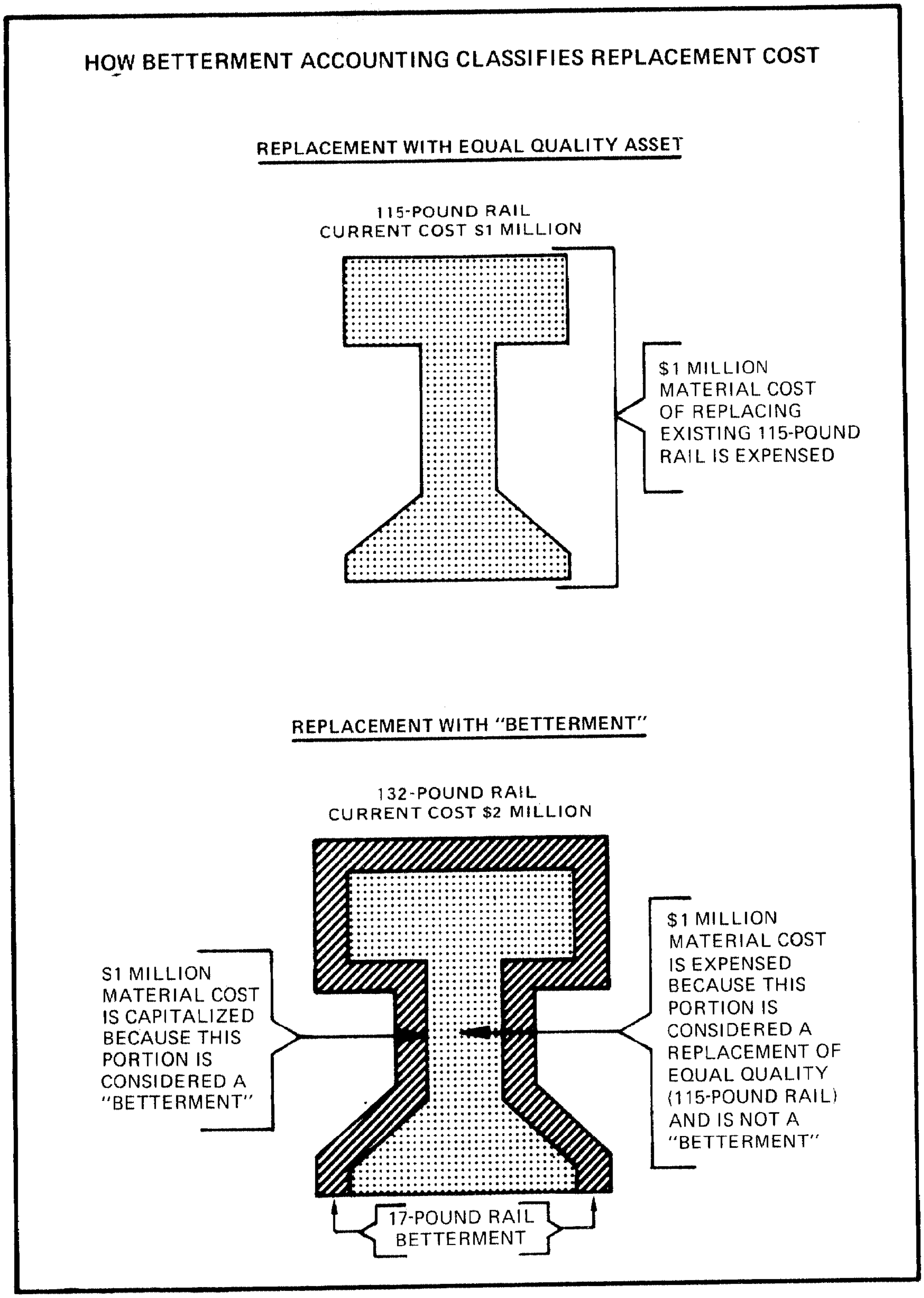
- --Track structure expenses for 1980 would be $3 million (the current cost of equal quality replacements).

Figure 1 (on the next page) clarifies the foregoing example by illustrating how betterment accounting classifies replacement costs for the rail.

While the railroad industry has employed betterment accounting since the 1800s, the method has been controversial for over 50 years. The ICC has questioned the appropriateness of betterment accounting for track structure on several occasions since the 1920s. In fact, ICC twice ordered depreciation accounting for track structures--in 1926 and 1931--but the orders were never put into effect.

Although betterment accounting is now unique to the railroad industry, many utilities used similar methods until the 1930s, when the Federal Power Commission began requiring utilities to use depreciation accounting for capital assets.

Figure 1


HOW BETTERMENT ACCOUNTING CLASSIFIES REPLACEMENT COST
REPLACEMENT WITH EQUAL QUALITY ASSET
115-POUND RAIL
CURRENT COST $1 MILLION
$1 MILLION MATERIAL COST OF REPLACING EXISTING 115-POUND RAIL IS EXPENSED
REPLACEMENT WITH "BETTERMENT"
132-POUND RAIL
CURRENT COST $2 MILLION
$1 MILLION MATERIAL COST IS CAPITALIZED BECAUSE THIS PORTION IS CONSIDERED A "BETTERMENT"
$1 MILLION MATERIAL COST IS EXPENSED BECAUSE THIS PORTION IS CONSIDERED A REPLACEMENT OF EQUAL QUALITY (115-POUND RAIL) AND IS NOT A "BETTERMENT"
17-POUND RAIL BETTERMENT

Regulators had developed opposition to utilities' capital asset accounting methods on several grounds, including determinations that the methods then employed permitted too much managerial discretion and often misstated income.

The Subcommittee on Legal and Monetary Affairs, House Committee on Government Operations, conducted hearings in 1957 to evaluate charges that ICC had not required the railroads to follow sound accounting principles and that the accounting procedures, including those for track, resulted in overstatement of profits. Because of these hearings, ICC was stimulated to review track structure accounting; however, no changes were made.

In 1957, the American Institute of Accountants' 1/ Committee on Relations with the Interstate Commerce Commission reviewed railroad accounting practices and reported that accounting for track components did not agree with practices followed by other industries. However, the committee concluded that the use of betterment accounting by the railroad industry was justified unless a change to depreciation accounting would provide more appropriate charges to income. The conclusion that betterment accounting was justified was based on (1) the long use of track accounting procedures, (2) the unique nature of the assets, (3) a stable quantity of track, and (4) the mature economic status of the industry.

Theoretical support of betterment accounting is based, in part, on the fact that betterment accounting accomplishes results similar to straight-line depreciation when there is a stable quantity of track structure, railroads perform prorata replacements, and price levels remain relatively constant. The theory is that replacements will occur throughout the life of a line and retirements will be staggered regularly--giving approximately the same results as would be achieved under straight-line depreciation.

From a practical consideration, supporters of betterment accounting believe it should be continued because (1) it is understood by groups familiar with the railroad industry, (2) it is a longstanding railroad industry accounting practice, and (3) it is sensitive to inflation. However, betterment accounting gives only a limited and obscure view of the effects of inflation on the railroads because it concerns only a portion of their operating costs--costs associated with track structure replacements.

1/Predecessor to the American Institute of Certified Public Accountants.

SEC and the Financial Accounting Standards Board--the accounting profession's standard-setting body--require major companies, including most Class I railroads, to provide pertinent supplemental financial information to disclose the effects of inflation. These requirements will provide comparable information on the effects of inflation on all major companies.

A comparative analysis of the two methods in terms of both theoretical and practical advantages reveals depreciation accounting to be the more effective measurement technique and we believe it should be adopted for the reasons discussed in the next chapter.

CHAPTER 3

DEPRECIATION ACCOUNTING SHOULD BE ADOPTED

Accounting is a system of measurement which provides quantitative financial information about an enterprise. As such it is intended to provide reliable financial information that is useful to owners, creditors, and others in making economic decisions. It does so by measuring the resources and obligations of an enterprise, as well as changes which occur in those resources and obligations during accounting periods. Depreciation accounting is more effective than betterment accounting as a measurement technique because depreciation accounting systematically allocates the cost of capital assets over their estimated useful lives.

The use of depreciation accounting for the track structure would:

--Improve expense recognition and net income determinations.

--Improve balance sheet presentations.

--Enhance comparability of financial information.

The principal payoff resulting from comparability is that it is helpful in contrasting operating results between railroad and railroad, or between railroad and another industry. Thus, it assists the Congress in deciding regulatory and subsidy questions, shippers in assessing rates, investors in making financial decisions, and Federal agencies in exercising regulatory responsibilities.

DEPRECIATION ACCOUNTING WOULD IMPROVE EXPENSE RECOGNITION AND NET INCOME DETERMINATIONS

Depreciation accounting provides the means to systematically and rationally allocate costs to each accounting period of a capital asset's estimated useful life. Once assets are ready for use, income is charged for using the assets. Determination of depreciation expenses is not dependent upon other actions, such as replacement of track structure materials, but rather is based on allocating the cost of existing track structure assets. Therefore, the amount of replacements in a period under depreciation accounting will not have a significant immediate effect on the reported cost of operations and reported net income, since only a portion of replacement costs will be expensed in the current period.

Under betterment accounting, the full cost of replacements of equal quality and retirements is included in the reported cost of operations for the current period and therefore has an immediate impact on net income. As railroads adjust the amount of track structure replacements to match the availability of cash or for other reasons, the reported cost of operations and net income determinations will reflect replacement decisions--during periods of accelerated maintenance, the cost of operations will be overstated and net income will be understated. Conversely, during periods in which maintenance is deferred, the reported cost of operations will be understated and the reported net income will be overstated.

DEPRECIATION ACCOUNTING WOULD IMPROVE BALANCE SHEET PRESENTATIONS

Use of depreciation accounting for track structures would improve railroads' balance sheet presentations. It would do so by ensuring that the track structure accounts reflect the cost of the assets in use as well as the accumulated depreciation charge to income for those assets. As assets are installed, their costs are recorded in the accounts and remain until the assets are replaced or retired. As a result, the track structure accounts reflect the cost of assets in use and associated accumulated depreciation.

The remaining undepreciated cost of an asset could thus be determined by subtracting the accumulated depreciation from the total cost reported for the asset. This net amount or book value represents the remaining cost of the asset available for allocation to future periods. This information facilitates analysis of such items as the adequacy of annual depreciation charges and is also used in determining certain financial ratios, such as the rate of return on investment--used by businesses, financial analysts, and investors in making financial decisions.

Under betterment accounting, the cost of the initial track materials and labor for a line remains in the accounts regardless of the number of times replacements occur. If superior quality replacements are installed, the cost of the betterment portion is added to the accounts and those costs will also remain in the accounts even though subsequent replacements occur. Therefore, under betterment accounting the track structure asset accounts do not show the cost of assets in use; rather, they show the cost of the original material and labor, supplemented by the betterment portion of replacements.

DEPRECIATION ACCOUNTING WOULD ENHANCE COMPARABILITY OF FINANCIAL INFORMATION

Making meaningful comparisons between railroads and other industries, and even among railroads, is difficult because the railroad industry uses betterment accounting, which is not used anywhere else. Adopting depreciation accounting would enhance the comparability of financial information--a desirable objective that is neither new nor limited to the railroad industry. A strong interest in more comparable financial information has been expressed by the accounting profession and the Congress.

Comparing railroad operations with those of other industries would help the Congress, shippers, investors, and the Federal agencies having regulatory responsibilities for the railroad industry make the decisions affecting the financial health of the industry. Adopting depreciation accounting would facilitate these comparisons.

The Financial Accounting Standards Board has taken the position that greater comparability makes financial information more useful and increases the credibility of financial reporting. The rationale is that the public is "skeptical about the reliability of financial reporting if two enterprises account differently for the same economic phenomena." 1/

Adopting depreciation accounting for track structures is consistent with the Board's interest in comparability since replacement expenditures in the railroad industry would be accounted for in a manner comparable to capital asset expenditures in other industries.

The Congress has also expressed its interest in improving financial reporting. The Subcommittee on Reports, Accounting, and Management of the Senate Committee on Governmental Affairs studied ways in which the accountability of publicly owned corporations could be improved, including the means of improving accounting standards. In November 1977, the Subcommittee issued a report culminating a 2-year inquiry into accounting practices and responsibilities of the Federal Government. The report, intended to be "a forceful and sound statement of public policy on accounting matters for Congress, the Securities and Exchange Commission, the accounting profession, and others," stated that uniformity in developing and

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1/"Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information," May 1980.

applying accounting standards must be a major goal in establishing such standards. The Subcommittee believed that using uniform accounting standards for the same types of business transactions would substantially improve the clarity and comparability of corporate financial statements.

Like events should be accounted for in like manner; i.e., differences between enterprises' financial statements should arise from the nature of their transactions and not merely from differences in accounting practices and procedures. Comparable accounting information, including revenues, expenses, and reported net income, facilitates conclusions concerning relative financial strengths and weaknesses and relative successes. Obviously, conclusions drawn from comparable information provide better bases for financial decisions.

Congressional need for comparable data

Comparable financial information would assist the Congress in considering the need for financial assistance to the railroad industry and the need for Federal regulatory reform. For example, deliberations on the staggers Rail Act of 1980 Public Law96-448--a bill to reform economic regulation of the railroads--compared rates of return earned by railroads to those earned by other industries as a measure of the financial health of the railroad industry. In 1979, railroads reported a 2.68 percent rate of return on net investment 1/ which has been compared with the return on investment in other industries. However, the Department of Transportation has stated that such comparisons are not valid due to the railroads' use of betterment accounting. Although comparisons of financial information are important and needed, a realistic comparison of railroads with other industries requires financial information based on comparable accounting methods.

Shippers are interested in comparable data

Shippers have complained to the Congress and ICC that the railroads' accounting methods--particularly betterment accounting--present a worse financial picture than actually exists. They contend that using betterment accounting overstates the cost of operations and understates net income, particularly when railroads are accelerating track structure replacements or are abandoning lines. Shippers and their representatives support adoption of depreciation accounting

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1/Rate of return on net investment = net railway operating income (net investment in transportation property and equipment + working capital).

for the track structure so that the financial results of railroads' operations will be more comparable to that of other industries.

Small investors would benefit from comparable data

Institutional investors and financial analysts use a variety of information to evaluate the future prospects of particular companies or industries. They do not rely exclusively on financial statements to make investment decisions, but obtain additional data for their analyses. Small investors may not have the capability to obtain this additional data and therefore must place greater reliance on published financial statements. Increased comparability of financial information will thus help the small investor.

Regulatory agencies' need for comparable and improved financial data

Use of depreciation accounting for the track structure will also help SEC and ICC fulfill their regulatory roles. SEC provides pertinent disclosure to the investing public and protects the interests of the public and investors against malpractice in the securities and financial markets. Adoption of depreciation accounting for track structures in reports to SEC and the public would provide current and potential investors with information that is comparable to financial reporting by other industries. Furthermore, it would rectify the current situation where some railroads use betterment accounting for the track structure in reports to SEC while others use depreciation accounting.

Adoption of depreciation accounting in reports to ICC would assist ICC staff, as evidenced by the Chairman's November 1979 statement to congressional committees that use of depreciation accounting would provide improved financial information and would also provide important information on railroad questions to other financial statement users. In addition, adopting depreciation accounting would be consistent with the ICC's objective of improved presentation of financial condition and operating results of regulated carriers.

In summary, depreciation accounting is a systematic method of allocating the cost of capital assets over their estimated useful lives. It produces a fair presentation of the cost of operations and net income. It also reports the cost of assets actually in use rather than assets which may have been replaced years ago. Since depreciation accounting is used by other industries, its use would enhance the comparability of railroads' financial reporting. It would assist the Congress in deliberations on regulatory reform and financial assistance to the railroads. Shippers would have better information to evaluate rates, and small investors would have more comparable information for decisions. Furthermore, depreciation accounting would help SEC and ICC fulfill their regulatory responsibilities. We believe that depreciation accounting will provide a number of benefits to those making financial decisions concerning the railroad industry, and should be adopted for the track structure. Our recommendations are presented in chapter 7.

CHAPTER 4

REGULATORY AGENCIES HAVE LONG BEEN

CONSIDERING ADOPTING DEPRECIATION ACCOUNTING

The two Federal regulatory agencies with authority over railroad industry accounting and reporting practices, the Securities and Exchange Commission and the Interstate Commerce Commission, have both expressed concern over use of betterment accounting. As a manifestation of this concern, each agency has issued an Advance Notice of Proposed Rulemaking about continuing use of betterment accounting. This is the initial step in the administrative process the agencies follow in changing accounting and reporting rules. However, for many months neither agency has proceeded beyond the Advance Notice, because SEC is waiting for ICC to act, and ICC has been waiting for the Federal income tax issue to be resolved.

SEC'S CONCERN: WHAT ARE THE EFFECTS OF DIFFERENT ACCOUNTING METHODS?

SEC is concerned about whether the reported results of operations are similar under betterment accounting and depreciation accounting. If not, it is interested in the magnitude of the difference. As a result of this concern, SEC issued an Advance Notice of Proposed Rulemaking in April 1977, announcing its intention to study the appropriateness of betterment accounting in documents filed with SEC and distributed to stockholders.

In February 1977, prior to issuing the Advance Notice, SEC asked the Financial Accounting Standards Board to consider the appropriateness of betterment accounting. However, the Board notified SEC that because of work already scheduled it would not be able to complete a project on betterment accounting for some time. The Board acknowledged that SEC should proceed with its own rulemaking to meet SEC requirements.

Passage of the Railroad Revitalization and Regulatory Reform Act of 1976, Public Law 94-210, (4-R Act) gave SEC authority to prescribe reporting rules and regulations for railroads to follow in reports to SEC and stockholders. Before passage of the act, SEC was precluded from prescribing reporting rules and regulations which would be inconsistent with regulatory agency requirements.

ICC's response to the Advance Notice urged SEC to postpone a decision on track structure accounting until implementation problems of adopting depreciation accounting were resolved. ICC asked SEC not to unilaterally adopt major accounting changes which would be inconsistent with the ICC Uniform System of Accounts for railroads.

SEC has not proceeded beyond the Advance Notice of Proposed Rulemaking and is not actively pursuing the subject, pending action by ICC. SEC officials said they would evaluate the results of ICC's review of track structure accounting before deciding whether changes in reporting requirements are necessary.

ICC'S CONCERN: DO CHANGES IN THE RAILROAD INDUSTRY WARRANT ACCOUNTING CHANGES?

While ICC currently requires betterment accounting for the track structure, it is considering adopting depreciation accounting. An October 1978 Advance Notice of Proposed Rulemaking stated ICC's belief that changes in the railroad industry, including increased Federal subsidization, large-scale rail line abandonments, and rehabilitation projects warranted reexamination of track structure accounting.

The Advance Notice acknowledged two other factors that are important in the current examination. First, five railroads adopted depreciation accounting for the track structure in reports to SEC and the public. Secondly, an April 1976 Department of Transportation petition suggested that ICC consider revising the accounting for the track structure. The petition stated that passage of the 4-R Act provided impetus to reconsider the appropriateness of betterment accounting, particularly in view of the Federal Government's huge financial commitment to improve the track system. The Department of Transportation questioned the role of accounting in railroad decisionmaking and expressed concern that betterment accounting might provide an incentive to defer maintenance.

In November 1979 letters to the House Committee on Ways and Means and the Senate Committee on Finance, the ICC Chairman stated that the Commission was seriously considering adoption of depreciation accounting. ICC preferred depreciation accounting because betterment accounting "may not adequately disclose railroad financial operating results and could mislead financial statement users." He also stated that the ICC staff believed that use of depreciation accounting would improve financial information and provide other financial statement users important data about railroad operating results. The Chairman added, however, that ICC would be reluctant to adopt depreciation accounting--even though it would be beneficial--unless betterment accounting remained available for tax purposes.

In our opinion, SEC and ICC, in questioning use of betterment accounting, are acting properly. SEC has questioned the effect of betterment accounting on the reported results of railroad operations and ICC believes depreciation accounting would provide improved financial information about the railroads. However, the tax issue has prevented the agencies from acting.

We believe SEC and ICC should complete without further delay their respective Advance Notices of Proposed Rulemaking and adopt depreciation accounting for the track structure. Our recommendations are presented in chapter 7.

CHAPTER 5

CONCERN OVER TAX INCREASES HAS PREVENTED ADOPTING DEPRECIATION ACCOUNTING

A change to depreciation accounting by the railroads for financial reporting purposes is likely to increase reported net income. Therefore if the railroads were required to use depreciation accounting for Federal income tax purposes, they would probably be liable for increased income taxes. Even so, the issues of financial accounting and tax accounting are not necessarily related. Determinations of proper financial accounting methods are not normally judged in light of their tax consequences. In many instances, businesses use different accounting methods for financial reporting and taxation purposes. However, given the substantial possible consequences, the Congress and the Treasury advanced proposals to mitigate the impact of higher taxes on the railroads.

Although depreciation accounting for the track structure will provide improved financial information that is more comparable to other industries', concern has been expressed about problems which may accompany a change from betterment accounting. The railroads stated to the Congress and ICC that a change to depreciation accounting will increase reported net income but will not provide more cash. They had been concerned in particular that higher reported net income under depreciation accounting would increase their tax liabilities. In addition, it could cause labor unions to seek wage increases, stockholders to expect greater dividends, and shippers to oppose rate increases. However, according to ICC officials, adopting depreciation accounting will not cause a material change in rates charged to shippers. Although these and other problems may develop, the question of Federal income taxes has been the major impediment to adoption of depreciation accounting. 1/

1/The problem of increased taxes resulting from conversion to depreciation accounting is no longer an issue since passage of Public Law 96-613, signed by President Carter on Dec. 28, 1980. Among other things, the new law prescribes betterment accounting as an acceptable method for Federal income tax purposes. There now is no reason that the railroads cannot use betterment accounting for income tax purposes and depreciation accounting for financial reporting purposes. Many such variations already exist between tax reporting and financial reporting.

Changing accounting methods for the track structure--from betterment accounting to depreciation accounting--can have a significant effect on reported net income for financial reporting purposes. If a change were also adopted for Federal income tax purposes, it would have a significant effect on tax liabilities. However, accounting for financial reporting purposes and accounting for Federal income tax purposes are separate issues and should be decided separately. Financial accounting for a company is intended to provide quantitative financial information which is useful in making economic decisions. Tax accounting is intended to provide information which assists in establishing a company's tax liability. As a consequence, many companies employ different accounting methods for financial reporting and taxation purposes because of the different effects they may have on reported net income.

EFFECTS ON NET INCOME OF ADOPTING DEPRECIATION ACCOUNTING

Theoretically, betterment accounting and depreciation accounting will achieve similar results over a number of years when (1) track mileage remains constant, (2) railroads are making pro-rata replacements, and (3) price levels remain relatively constant. However, these conditions do not currently exist and, as a consequence, net income determinations are significantly different between betterment accounting and depreciation accounting.

One reason differences in reported net income occur is because depreciation accounting allocates the cost of replacements over their estimated useful lives, while betterment accounting expenses the cost of replacements of equal quality as they occur. Therefore, replacement expenses under betterment accounting affect only one year, while they affect a number of years under depreciation accounting because costs are allocated over the periods benefited. Unusually large or small replacements in a year will have a pronounced effect on net income under betterment accounting because the cost of replacements of equal quality will be recorded as expenses for the year. Under depreciation accounting only a portion of the cost of replacements during the year is included in expenses for the year because of the systematic allocation of costs, so the effect of large or small replacements is allocated over a number of years.

To determine the potential effect that a change to depreciation accounting would have had on net income in recent years, we selected 10 high-revenue Class I railroads and restated their net incomes for 3 years. Although not necessarily precise restatements of net income under depreciation accounting, our figures indicate the anticipated results of a change from betterment accounting. The methodology used for the net income restatement and the underlying assumptions are explained in appendix I. In addition, appendix I presents net income data for each of the 10 railroads for the 3 test years.

	Average net income after taxes for 10 railroads		Average increase in net income after taxes due to depreciation accounting	
	Using betterment accounting	Using depreciation accounting	Amount	Percent
	(millions)			
1976	$84	$112	$28	33
1977	$95	$127	$32	34
1978	$99	$134	$35	35

The net income restatement indicates that net income after taxes would have been considerably higher if the 10 railroads had used depreciation accounting for the track structure during the 3 test years. However, a change to depreciation accounting would not always increase net income. For example, a change to depreciation accounting during World War II would have decreased net income because shortages of material and staffing caused railroads to defer maintenance and, as a consequence, they had fewer track structure expenses.

EFFECT ON TAXES IF DEPRECIATION ACCOUNTING WERE ADOPTED FOR FEDERAL INCOME TAXES

Even before passage of Public Law 96-613, a change to depreciation accounting for financial reporting purposes would not necessarily have affected the railroads' Federal income tax liability. However, railroads, ICC, and others believed that Federal income taxes would increase if the Internal Revenue Service had required railroads to use depreciation accounting for tax purposes.

Although the magnitude of the potential increase in Federal income tax liability is uncertain, the Association of American Railroads developed two estimates of the potential increase. One estimate (see fig. 2) predicted a net $2.27 billion increase in Federal income tax liability for the industry over the 30 years ending in 2006. Another Association estimate (see fig. 3) predicted a $1.77 billion net increase in tax liability for three selected railroads during the 20 years ending in 1998.

Figures 2 and 3 depict the results of the Association's studies.

Figure 2

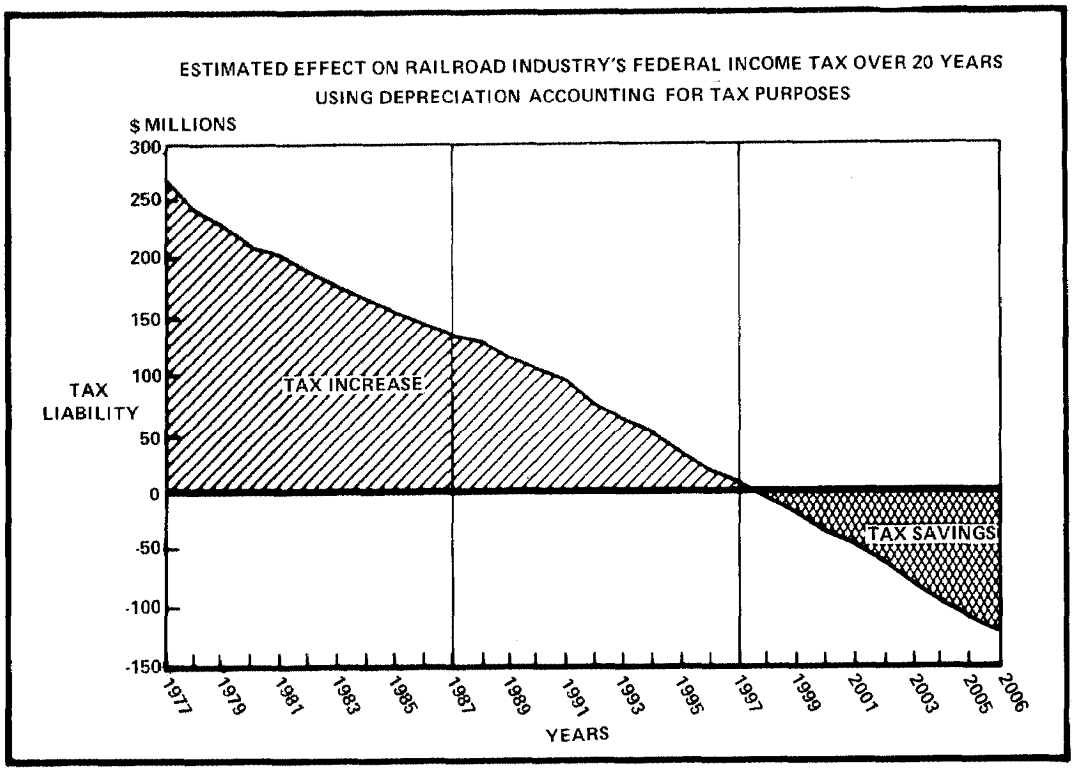
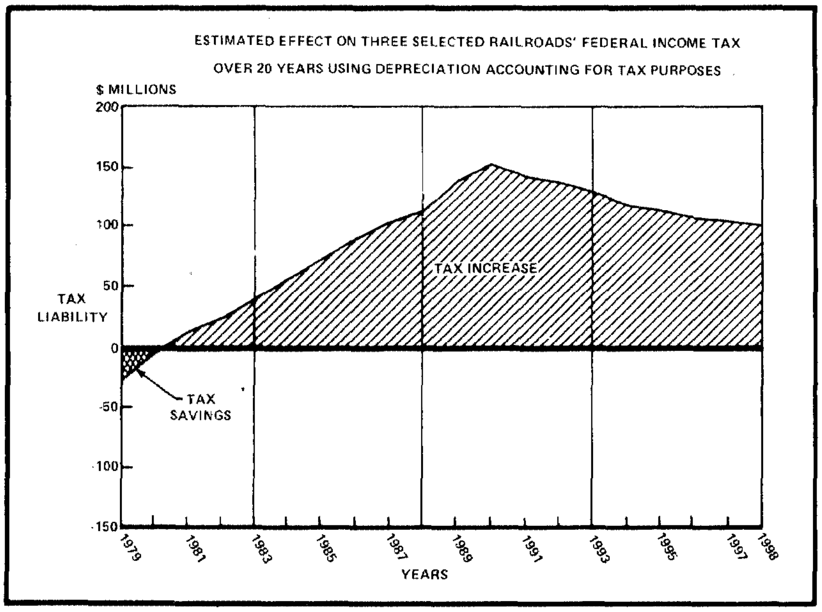


Figure 3



We did not verify the estimates nor determine their reliability. However, the study of the industry tax liability did not restate existing assets nor account for anticipated inflation. According to a Treasury representative, the Association's study of the three railroads used criteria developed by the Treasury which included conservative inflation estimates. The Treasury representative also said that the study contained a procedural error which, if corrected, would not change the total increased tax liability but would change amounts for individual years. Tax savings reported for the first 2 years would be eliminated.

Before enactment of Public Law 96-613, the Department of the Treasury stated that betterment accounting should be discontinued for Federal income tax purposes if ICC changed to depreciation accounting for the track structure. ICC, the railroads, and others have been concerned that changing to depreciation accounting for Federal income tax purposes could increase taxes and cause a cash drain on the industry.

Railroads have been allowed to use betterment accounting in determining taxable income since imposition of the Federal income tax in 1913. While betterment accounting was not specifically prescribed in the Internal Revenue Code as an acceptable depreciation method, it had been accepted by the Internal Revenue Service and by the courts, principally because of its use by ICC. As a result, before passage of Public Law 96-613, the Internal Revenue Service could have ruled that betterment accounting did not fairly present income, and stopped its further use for tax purposes if ICC had prescribed depreciation accounting for regulatory purposes.

Treasury testified before the Congress in September and October 1979 that betterment accounting was not appropriate for tax purposes and its use should be discontinued if ICC disallowed it. Treasury stated that betterment accounting:

--Does not clearly reflect income because it allows railroads to increase capital expenditures and immediately reduce tax liabilities, while other industries must spread deductions over several years.

--Amounts to indexing depreciation and is not available to other industries.

--Is subject to abuse because costs can be improperly allocated between the track structure and depreciable assets when a railroad is acquired. The allocation of cost affects the amount of depreciation expense claimed in subsequent years in determining Federal income tax liabilities.

--Would be a burden on the railroads and the Internal Revenue Service if used for tax purposes only. Additionally, a change to depreciation accounting would reduce the number of tax disputes.

PROPOSALS INCLUDE WAYS TO DIMINISH TAX IMPACT

Proposals have been advanced to diminish the Federal income tax impact on railroads resulting from a track structure accounting change. Public Law 96-613 codified betterment accounting as an acceptable method for Federal income tax purposes. A Department of the Treasury proposal discussed in congressional hearings during 1979 would have allowed a gradual transition to depreciation accounting for tax purposes.

Railroads, ICC, financial analysts, and the accounting profession supported the legislation which ensures continued availability of betterment accounting for Federal income tax purposes regardless of changes by ICC for regulatory purposes. Passage of the legislation resolved the tax question because railroads may continue using betterment accounting for Federal income tax purposes.

Treasury's proposal would have required the railroads to use depreciation accounting for Federal income tax purposes, but would have allowed additional deductions during a transition period to minimize the impact on the railroads. After the transition period, the railroads would have been on a tax basis comparable to other industries.

Both accounting for financial reporting purposes and accounting for Federal income tax purposes provide quantitative financial information about an enterprise, but they do so for different purposes and therefore each should be viewed independently. We are interested in the appropriateness of accounting methods prescribed by ICC and SEC for use by the railroad industry as part of the agencies' oversight responsibilities. Accounting for financial reporting purposes should be evaluated on its ability to provide meaningful, unbiased data.

We believe that depreciation accounting provides a better measure of the cost of railroad operations and it should be adopted for financial reporting purposes regardless of the accounting method used for tax purposes. Our recommendations are presented in chapter 7.

CHAPTER 6

DEFERRED MAINTENANCE SHOULD BE REPORTED

Thousands of miles of track structure are in poor condition because the railroads have not performed maintenance. It has been suggested that a relationship exists between deferred maintenance and railroads' accounting practices. The implication is that had the railroads used depreciation accounting, the deferred maintenance problem would not have occurred. For reasons we will explain we do not agree.

The effects of certain accounting methods on financial reporting could conceivably influence management decisions. However, we doubt whether use of a particular accounting method is the driving force behind decisions to spend money to maintain the track structure or to defer maintenance. Other factors enter into these decisions. One of these factors, which may well be the major factor, is a lack of cash. Another factor influencing the decision to defer maintenance is a railroad's future plans for a line.

Although deferred maintenance information has been reported to ICC for several years, we believe such information should also be required as part of a railroad's financial reporting to SEC, its stockholders, and others having a financial interest in the industry. SEC is considering deferred maintenance reporting requirements.

WHAT IS DEFERRED MAINTENANCE?

"Deferred maintenance" is a term which generally describes the results of railroad decisions not to perform track structure maintenance. Although the term is widely used, there is no widely accepted definition. ICC and the Department of Transportation each have defined deferred maintenance for their own purposes, but acknowledge the absence of a universally accepted definition. SEC also recognized the lack of a definition when it issued an Advance Notice of Proposed Rulemaking which requested comments and suggestions on development of a uniform methodology for computing deferred maintenance amounts and standards for disclosing them. A previous GAO report stated that no complete or reliable data existed which objectively described the physical condition of the railroad industry or provided reliable estimates of systemwide rehabilitation needs and costs. 1/

1/"Information Available on Estimated Costs to Rehabilitate the Nation's Railroad Track and a Summary of Federal Assistance to the Industry" (RED-76-44, Nov. 21, 1975).

CLASS I RAILROADS ARE REQUIRED TO REPORT DEFERRED MAINTENANCE TO ICC

As part of a nationwide freight rate increase in 1974, ICC began requiring Class I railroads to periodically report the estimated costs of deferred maintenance of plant and equipment and delayed capital improvements. ICC defined "deferred maintenance" as

> "* * *the accrued deterioration or deficiency in the physical operating condition of railroad track structures, cars and locomotives, and other property used in the provision of transportation service resulting from the failure and/or inability to properly maintain plant and equipment, which produces an adverse effect on railroad operations to an extent that services to shippers have been rendered partially or wholly inadequate and/or has resulted in diminishing the railroads' competitive ability;* * *."

The Class I railroads must now include deferred maintenance information in annual reports to ICC. The ICC deferred maintenance definition provides a common starting point, but allows each railroad to report information that represents its respective operations and physical conditions. As of December 31, 1978, 1/ the railroads reported that track structure maintenance amounting to about $1.3 billion had been deferred. This includes replacement of an estimated 22 million ties and 2 million tons of rail.

The Consolidated Rail Corporation (Conrail) was allowed to report that it had no deferred maintenance because it did not cause the deferrals or associated track deterioration that existed when Conrail assumed operations of seven Class I railroads. The predecessor railroads reported track structure deferred maintenance totaling $909 million as of June 1974--the first reporting date for deferred maintenance information.

Our March 1980 report discussed Conrail's plan to reduce track expenditures below appropriate maintenance levels during 1980 and 1981 in order to stay within the $3.3 billion Federal commitment to the corporation. 2/ The report concluded that

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1/The last year for which complete information is now available.

2/"Conrail's Reduced Capital Program Could Jeopardize the Northeast Rail Freight System" (CED-80-56, Mar. 10, 1980).

cutbacks in capital spending pose an unacceptable risk to the Federal investment in Conrail.

Another way of determining the extent of deferred maintenance is to look at the effects of deteriorating track on railroad operations. The effects can be so severe as to cause derailments or necessitate reduced speeds over certain sections of track. For the period ended December 31, 1978, the railroads reported to ICC that over 41,000 miles of track were subject to "slow orders."

ICC's collection of deferred maintenance information is a positive step. The information provides increased disclosure about the condition of the railroad industry and individual carriers. Although annual reports to ICC are public information and can be obtained through ICC, they are not as readily available as reports to SEC and annual reports to stockholders.

DEPARTMENT OF TRANSPORTATION REPORT DEFINED AND ESTIMATED DEFERRED MAINTENANCE

The Railroad Revitalization and Regulatory Reform Act of 1976, Public Law 94-210 (4-R Act), directed the Secretary of Transportation to develop information on the industry's facilities rehabilitation and improvement needs and to make preliminary recommendations on the amount and type of assistance needed. In an October 1978 report 1/ prepared in response to the 4-R Act requirements, the Secretary reported that the amount of deferred maintenance in the industry had increased by $5.4 billion during the 10 years ending in 1976. However, some portion of the total had resulted from decisions made in connection with changes in operating patterns, service policies, or anticipated line abandonments.

The $5.4 billion increase represented the estimated expenditures necessary for railroads to achieve a level of "normalized" maintenance, which the Secretary defined as "the level of railroad maintenance-of-way expenditures necessary to ensure that, on the average, one-half the useful life remains in the components of the railroad track system."

1/"A Prospectus for Change in the Freight Railroad Industry, A Preliminary Report by the Secretary of Transportation."

SEC IS CONCERNED OVER HOW DEFERRED MAINTENANCE IS CALCULATED AND HOW IT SHOULD BE REPORTED

In April 1977, SEC issued an Advance Notice of Proposed Rulemaking concerning the appropriateness of betterment accounting and the problem of deferred maintenance. The Advance Notice requested comments and suggestions on the development of a uniform methodology for calculating amounts of deferred maintenance and standards for disclosing them. It also stated SEC's belief that significant amounts of deferred maintenance are of material interest to stockholders and that, until industrywide guidelines are established, each railroad should disclose material amounts of deferred maintenance in a manner the carrier believes appropriate.

Selected responses to the SEC inquiry into deferred maintenance

A number of organizations, including Federal agencies, railroads, financial analysts, and accounting firms, responded to the SEC Advance Notice. Respondents generally acknowledged that information about the physical condition of the track structure should be disclosed. Some representative responses follow.

Department of Transportation and ICC responses

The Department of Transportation responded that deferred maintenance was an area of concern and that footnotes to balance sheets should disclose average service lives for categories of capital assets, the amounts of deferred maintenance, and the method of calculating them.

ICC notified SEC in June 1977 that it was also considering reporting requirements for railroad track maintenance and cautioned SEC that separate approaches to deferred maintenance reporting requirements could result in inconsistent conclusions, which could be a disservice to the investment community.

Accounting profession responses

Representatives of the accounting profession suggested varying methods of disclosure, including a 10-year summary of replacements, a 5-year plan for replacements, management discussion of maintenance/replacement practices, engineering estimates of the useful life of rails and ties, and statistics on slow orders. They did not suggest including information within the financial statements, but rather they intended supplemental information be furnished to disclose a railroad's maintenance and replacement activities so that its financial condition could be appropriately evaluated. One response suggested that a study of deferred maintenance could result not only in disclosure of problems in the railroad industry, but also in a system for disclosing plant maintenance problems in all industries.

Railroad industry responses

Industry respondents stated that information about deferred maintenance should be included in reports to stockholders. The Association of American Railroads suggested rail and tie replacement data and expressed concern that the industry could be subjected to conflicting requirements. As a precaution, the Association suggested that SEC coordinate its actions with those of ICC and other government agencies. A Class I railroad advocated presentations of (1) capital replacement plans for the current year, (2) replacements installed since the immediately preceeding report, (3) material variances between actual and planned replacements for the period, and (4) an objective appraisal of the condition of the property.

Financial analysts' responses

Financial analysts, in responding to SEC, to ICC on track structure accounting, and in discussions with us, stated their interest in a comprehensive presentation of information regarding track structure assets. They believed increased disclosure, particularly in annual reports to stockholders, was needed. Suggested information included:

--An explanation of management's maintenance philosophy for the past 10 years.

--An assessment of whether the railroad is over- or under-maintained or reasonably maintained.

--Statements on the adequacy of the roadbed relative to 10-year traffic volume projections.

--Data for 5 years on types and amounts of track structure materials installed, including prices to show the effects of inflation.

--Number of "slow orders" in effect, which are good indicators of deferred maintenance.

FACTORS OTHER THAN ACCOUNTING METHODS CONTRIBUTE TO DEFERRED MAINTENANCE

Betterment accounting has been criticized because it can provide incentives to defer track structure expenditures as a means of reporting higher earnings. However, the Association of American Railroads, ICC, and others have stated that no relationship exists between deferred maintenance in the industry and betterment accounting. Rather, they attribute the existence of deferred maintenance to the railroads' financial difficulties and lack of sufficient cash or other means to finance maintenance, and not to the use of betterment accounting. The existence of deferred maintenance in other industries and in many large cities, none of which use betterment accounting, supports the belief that other factors give rise to the deferred maintenance problem.

The October 1978 Department of Transportation report on the railroad industry enumerated the following critical factors contributing to the decline and poor financial health of the industry:

> "Basic changes have occurred in traditional rail markets, as heavy industry gave way to a service-oriented, high-technology economy and as shifts have occurred in the location of industry.
>
> "Regulatory constraints have impinged upon management's ability to adjust rates, merge corporate entities, abandon facilities and services, and improve productivity.
>
> "Government provision of highways, waterways, airways, and other facilities, which--in areas where user charges are inadequate--has subsidized the rail industry's principal competitors.
>
> "The railroad industry has been slow in adapting to new technology; rival modes have been more successful in making use of new developments.
>
> "Labor unions and management have not been able to agree on methods for full implementation of changes that would increase productivity, despite substantial increases in wages and benefits."

An additional complication for the railroads as they try to correct their financial problems is that some of these factors are beyond their control.

Deferred maintenance can adversely affect operating efficiency, earnings, and future prospects. Information about the physical condition of track structure is therefore needed by the Congress, regulators, investors, shippers, and others to make decisions affecting the railroads and their own businesses and financial interests. Information on a railroad's maintenance and replacement practices--including deferred maintenance information--should be included in financial reports and be readily available to the above groups. Actions to disclose the extent of deferred maintenance, which ICC has taken and SEC is considering, are steps in the right direction. We believe ICC's requirement for deferred maintenance reporting by the railroads is a positive step which should be accompanied by comparable requirements for reporting to SEC and stockholders so that this information is readily available. Our recommendations are presented in the next chapter.

CHAPTER 7

CONCLUSIONS, AGENCY COMMENTS AND OUR EVALUATION, AND RECOMMENDATIONS

CONCLUSIONS

The issue of track structure accounting has been debated for over 50 years. Although use of betterment accounting may once have been warranted, changes in the railroad industry and the environment in which it operates have caused ICC and SEC to question the continued use of betterment accounting. Both agencies are considering the adoption of depreciation accounting for the track structure.

Accounting is essentially a system of measurement and, in our opinion, depreciation accounting is superior to betterment accounting as a measurement technique. This is so because depreciation accounting systematically and rationally allocates the cost of capital assets over their estimated useful lives, whereas betterment accounting does not. As a result, depreciation accounting produces a fair presentation of the cost of operations and net income. It also shows the cost of assets in use rather than assets which may have been replaced years ago. Since depreciation accounting is used by other industries its adoption would enhance the comparability of railroads' financial reporting. Use of depreciation accounting would assist the Congress in considering regulatory reform and financial assistance to railroads. Shippers would have better information for evaluating rates and small investors would have more comparable information for making decisions. Furthermore, depreciation accounting would help ICC and SEC fulfill their regulatory responsibilities.

ICC and SEC are considering whether depreciation accounting for the track structure should be adopted, but the Federal income tax problem has been considered a major obstacle to the change. We are also concerned about the financial well-being of the railroads and do not want to worsen the problem. However, accounting for Federal income tax purposes and accounting for financial reporting purposes are separate issues--one does not "drive" the other.

We believe that depreciation accounting would provide a better measure of railroads' operating costs; it would enhance the comparability of railroads' financial reporting; it would be helpful to those making financial decisions related to the railroad industry; and it should be adopted.

In addition to recommending adoption of depreciation accounting we also believe that deferred maintenance information should be required as part of a railroad's financial reporting to SEC, stockholders, and others having a financial interest in railroads.

Because the track structure is critical to the operation of the railroad industry and accounts for about one-half of its assets, it is vital that the physical condition of the track structure be known.

The Congress, regulators, investors, shippers, and others must be able to evaluate capital asset maintenance and replacement efforts. Deferred maintenance can adversely affect operating efficiency, earnings, and future prospects. Consequently, information on a railroad's maintenance and replacement practices--including deferred maintenance information--should be included in financial reports and be readily available to the above groups.

ICC has been requiring Class I railroads to report the estimated amounts of deferred maintenance of plant and equipment. Interested parties may obtain this information from ICC. Although such information is "public," it should be more readily available. Therefore, information on deferred maintenance should be included in railroads' reports to SEC and annual reports to stockholders.

Both ICC and SEC have certain regulatory, accounting, and financial reporting responsibilities for the industry. They should ensure that information concerning the industry is available to interested parties. Their efforts should not result in conflicting requirements.

AGENCY COMMENTS AND OUR EVALUATION

The Chairman, Interstate Commerce Commission, and the Chairman, Securities and Exchange Commission, provided written comments on our recommendations that ICC and SEC adopt depreciation accounting for the track structure and also on our recommendations concerning reporting of deferred maintenance information. The Department of the Treasury provided written comments concerning use of depreciation accounting for Federal income tax purposes. These comments have been included in their entirety as appendixes II, III, and IV. A summary of the agency comments and our evaluation of those comments follows.

Adopting depreciation accounting

ICC agrees with our position that benefits would accrue to financial statement users if railroads adopted depreciation accounting for the track structure. However, ICC believes these benefits would be outweighed by the increased Federal income taxes that would result if an accounting change were made. These increased taxes, according to ICC, could undermine the financial stability of even the healthiest railroads. ICC stated that once the tax issue is resolved, it would resume its consideration of adopting depreciation accounting for track structure.

ICC's opposition to changing accounting methods has been based on its belief that Federal income taxes would increase. However, the Treasury Department, in responding to our draft report, stated that an accounting change could be made without increasing the railroads' Federal income taxes. In fact, according to Treasury's response, a change from betterment accounting to depreciation accounting would result in a significant tax decrease. Treasury proposed that a change to depreciation accounting for Federal income tax purposes be made at the time that depreciation allowances are increased for all taxpayers. Treasury believes the 97th Congress will consider amendments to the Internal Revenue Code which will allow increased depreciation allowances and will simplify depreciation methods. Furthermore, Treasury did not favor any administrative action by the Internal Revenue Service until the Congress had an opportunity to consider depreciation legislation.

We too are concerned about the financial stability of the railroad industry and it was not our intent to propose that a change to depreciation accounting be made regardless of the tax impact. We believe Treasury is also concerned about the financial health of the railroads as evidenced by its willingness to work out a solution that would have mitigated, or even eliminated, the impact of higher taxes on the railroads. Treasury has demonstrated in statements to the Congress and in written comments to us that depreciation accounting for the track structure could be adopted without increasing the railroads' Federal income tax liability. We do not agree with ICC that by adopting depreciation accounting for financial reporting purposes the railroads would necessarily face a Federal income tax increase.

After ICC, SEC, and Treasury commented on our proposals, the Congress passed legislation which, among other things, prescribes betterment accounting as an acceptable depreciation method for Federal income tax purposes. This bill was signed by President Carter on December 28, 1980, and became Public Law 96-613. Since the law prescribes betterment accounting as an acceptable depreciation method, the Internal Revenue Service is now required to accept betterment accounting for income tax purposes and the question of increased taxes resulting from conversion to depreciation accounting is no longer an issue. There is no reason that the railroads cannot use betterment accounting for income tax purposes and depreciation accounting for financial reporting purposes. Many such variations already exist between tax reporting and financial reporting. We believe the recognized benefits for financial reporting purposes are so overriding that immediate action requiring depreciation accounting for the track structure is justified.

SEC agreed with our position that depreciation accounting is a more effective measurement technique than betterment accounting. However, SEC is deferring action on its consideration of a change to depreciation accounting for track structure--initiated in 1977--until ICC completes the study of track structure accounting it initiated in 1978. To do otherwise, SEC believes, could burden users of financial statements with two methods of reporting for fixed assets.

Although SEC's stated position is to defer action for the time being, its comments imply that it is not fully convinced that depreciation accounting should be adopted for the track structure. SEC does not agree that a change to depreciation accounting would so improve financial statement presentations that other considerations should be disregarded. Without explaining what "other considerations" would be disregarded, SEC gave two reasons why it believes a change would not significantly improve financial statement presentations.

One reason for not adopting depreciation accounting is the effect of changing prices. SEC believes that the effect of changing prices has somewhat diminished the value of historical cost-based financial statements. The implication is that betterment accounting is more sensitive to inflation than depreciation accounting. However, as stated in our report, betterment accounting gives only a limited and obscure view of the effects of inflation on the railroads because it concerns only a portion of their operating costs--costs associated with track structure replacements. Furthermore, no costs are recognized for current use of existing track structures.

We recognize that the effect of changing prices resulting from inflation and other factors is of concern to financial statement users. However, this problem is not limited to the railroad industry and it is being addressed by the Financial Accounting Standards Board--the accounting profession's standard-setting body. SEC has supported the work of the Financial Accounting Standards Board and has encouraged its efforts to deal with the problem of reporting the effect of changing prices.

The Board requires major enterprises to supplement the historical cost-based financial statements with information on the effect of changing prices due to inflation and other factors. The primary financial statements are not changed; the required information is presented in supplementary statements, schedules, or notes in financial reports. As a result the primary financial statements are still based on historical prices. The effects of changing prices can be determined by comparing these primary financial statements with the supplementary information.

We do not agree with SEC's rationale that depreciation accounting should not be adopted because price changes resulting from inflation and other factors have diminished the value of historical cost-based financial statements. We believe that depreciation accounting should be adopted now because (1) the effects of inflation and other changing prices are being addressed, (2) all other railroad depreciable assets are already under depreciation accounting, and (3) railroad financial statements would be more comparable with those of other industries.

SEC's second reason for not agreeing that a change to depreciation accounting would significantly improve financial statement presentations is that betterment accounting has been used for many years and, as a consequence, financial statement users understand it and make allowances for its effects.

We do not think that all users of railroad financial statements fully understand betterment accounting or make appropriate allowances for its effects. For example, during congressional hearings on rail deregulation, the financial health of the railroad industry and the return on net investment were discussed. We doubt that allowances were made for betterment accounting; nevertheless, railroads' return on net investment was compared with the return of other industries that were using different accounting methods.

Even if proper allowances were made, we would recommend a change to depreciation accounting because it would enhance comparability within the railroad industry and between railroads and other industries. Within the railroad industry all assets except the track structure are already under depreciation accounting. The change would enhance comparability within railroads and allow easier, more meaningful comparisons between railroads and other industries. We are particularly concerned about SEC's position that the railroads' long use of betterment accounting and the allowances that are made for its use are reasons for not changing to depreciation accounting. This position is at variance with other SEC positions supporting more comparability. For example, persons who are opposed to making accounting changes to adjust for the effects of inflation make a similar argument--that because investors and analysts make allowances, no changes are needed. SEC, as stated earlier, has supported the Financial Accounting Standards Board in this matter and, in effect, rejects the argument that if allowances are made for differences, accounting changes are not needed.

Deferred maintenance reporting requirements

ICC fully agreed with our recommendation that future changes in deferred maintenance reporting requirements be coordinated with SEC to guard against conflicting requirements being placed on the railroad industry. ICC stated that its policy has been to coordinate reporting changes with SEC and this will continue.

SEC was responsive to our recommendation that railroads be required to report deferred maintenance information. However, SEC is deferring action until such time as it can be coordinated with a proposal relating to track structure accounting.

SEC is concerned that since there is no widely accepted definition of deferred maintenance, there is no practical way to obtain meaningful reporting. SEC is proposing that railroads be required to report appropriate statistical information concerning maintenance work performed in recent years in a form that does not conflict with ICC requirements.

We recognize that there is not a widely accepted definition of deferred maintenance. We also recognize that it may be possible to satisfy the Commission in various ways--providing statistical information being one. Our concern is that deferred maintenance information be reported. The definitions, methodology, and reporting techniques still need to be decided.

ICC and SEC generally agree that depreciation accounting is a more effective measurement technique. They also agree that deferred maintenance information should be reported. However, rather than moving to resolve the problems, ICC and SEC are again deferring action. As stated above in our evaluation of their comments, we do not believe that the reasons advanced by the Commissions should be impediments to their accepting our suggestions. With the enactment of Public Law 96-613, which prescribes betterment accounting as an acceptable method for Federal income tax purposes, the question of increased taxes resulting from conversion to depreciation accounting is no longer an issue. We believe that accounting for the track structure, which has already been discussed for over 50 years, will not be settled by further deferral of decisions.

RECOMMENDATIONS

We recommend that the Commissioners of the Interstate Commerce Commission:

--Complete the October 1978 Advance Notice of Proposed Rulemaking and adopt depreciation accounting for the track structure.

--Coordinate future changes in deferred maintenance reporting requirements with the Securities and Exchange Commission to guard against conflicting requirements being placed on the railroad industry.

We recommend that the Commissioners of the Securities and Exchange Commission:

--Complete the April 1977 Advance Notice of Proposed Rulemaking on railroad accounting by adopting depreciation accounting for the track structure.

--Complete the study of deferred maintenance reporting covered by the April 1977 Advance Notice of Proposed Rulemaking, and require railroads to report deferred maintenance information which fulfills SEC needs yet does not conflict with ICC requirements.

METHODOLOGY USED TO RESTATE NET INCOME

USING DEPRECIATION ACCCOUNTING

To determine how the use of depreciation accounting would have affected railroads' reported net income for individual years, we selected 10 Class I railroads that had the highest revenue from railroad operations in 1977 (excluding one railroad controlled by another Class I railroad) and use betterment accounting in reports to stockholders. We restated their reported net incomes for calendar 1976, 1977, and 1978 using depreciation accounting. The detailed restatement results for the 10 railroads are presented in tables 1, 2, and 3 of this appendix and are summarized in chapter 5 of this report. (See p. 21.)

The net income restatement procedures were based on several broad assumptions derived from discussions with an ICC official, a railroad industry official, and a consultant on railroad industry matters. The procedures were uniformly applied to financial reports submitted to ICC by the 10 Class I railroads. The assumptions and procedures do not necessarily result in precise restatements of what net incomes would have been had the railroads used depreciation accounting. They do, however, show that a change to depreciation accounting for the track structure by the 10 railroads during 1976, 1977, or 1978 would probably have increased reported net incomes by material amounts.

The restatement for each year assumes the railroads changed to depreciation accounting in that year. Therefore, changes in net income are not cumulative and changes for past or future years should not be extrapolated from the net income restatements for 1976, 1977, or 1978.

Restatement assumptions

The following assumptions were used in the net income restatement:

- --Ninety percent of the track structure expenses for 1976, 1977, and 1978 were capitalized.
- --The amounts capitalized in 1976, 1977, and 1978 were depreciated over 30 years on a straight-line basis, recognizing a salvage value of 25 percent.
- --The amounts for the existing track structure were not restated to reflect use of depreciation accounting in earlier years.

--The amounts for the existing track structure were depreciated over 20 years on a straight-line basis, recognizing a salvage value of 40 percent.

--Federal income taxes were applied to the increases in adjusted net income at a rate of 48 percent for 1976, 1977, and 1978.

--Ad valorem taxes were applied to the increases in adjusted net income before taxes at a rate of 2 percent.

Restatement procedures

The following formula restates net income to reflect use of depreciation accounting:

$$A + (1-.48)\ [.9B - (C + D + F)] = G$$

Where:

A = Net income using betterment accounting for the track structure (as reported to ICC).

B = Track structure expense for the year under betterment accounting.

C = Ad valorem taxes on the increase in adjusted net income before taxes resulting from use of depreciation accounting.

D = Depreciation expense on the amounts capitalized in 1976, 1977, and 1978 $\left(\frac{.75 \times .9B}{30}\right)$.

E = Existing track structure assets at the end of the year.

F = Depreciation expense on the existing track structure $\left(\frac{0.6 \times E}{20}\right)$.

G = Net income after taxes using depreciation accounting for the track structure.

Table 1

Comparison of net incomes after taxes under betterment and depreciation accounting

1976

Railroad	Accounting method used: Betterment	Accounting method used: Depreciation	Difference	Percentage
	(thousands)			
A	$ 72,588	$ 136,086	$ 63,498	87.5
B	81,263	111,690	30,427	37.4
C	55,096	89,385	34,289	62.2
D	106,156	138,059	31,903	30.1
E	131,522	157,531	26,009	19.8
F	88,844	115,224	26,380	29.7
G	85,373	103,736	18,363	21.5
H	31,407	50,171	18,764	59.7
I	92,549	112,507	19,958	21.6
J	99,171	111,261	12,090	12.2
Total	$843,969	$1,125,650	$281,681	
Average	$84,397	$112,565	$28,168	33.4

Table 2

Comparison of net incomes after taxes under betterment and depreciation accounting

1977

Railroad	Accounting method used Betterment	Depreciation	Difference	Percentage
	--------------(thousands)	-------------		
A	$ 74,903	$ 138,290	$ 63,387	84.6
B	79,586	114,176	34,590	43.5
C	75,289	118,565	43,276	57.5
D	116,262	152,593	36,331	31.2
E	103,435	132,972	29,537	28.6
F	108,882	140,090	31,208	28.7
G	103,037	124,134	21,097	20.5
H	85,113	105,491	20,378	23.9
I	110,546	137,394	26,848	24.3
J	89,898	104,251	14,353	16.0
Total	$946,951	$1,267,956	$321,005	
Average	$94,695	$126,796	$32,101	33.9

Table 3

Comparison of net incomes after taxes under betterment and depreciation accounting 1978

Railroad	Accounting method used: Betterment	Accounting method used: Depreciation	Difference	Percentage
	(thousands)			
A	$113,550	$ 188,436	$ 74,886	65.9
B	49,369	86,576	37,207	75.4
C	92,539	136,351	43,812	47.3
D	141,801	184,855	43,054	30.4
E	167,597	189,997	22,400	13.4
F	101,139	130,457	29,318	29.0
G	69,354	90,891	21,537	31.1
H	55,029	80,442	25,413	46.2
I	131,194	165,935	34,741	26.5
J	68,865	87,479	18,614	27.0
Total	$990,437	$1,341,419	$350,982	
Average	$99,044	$134,142	$35,098	35.4

Interstate Commerce Commission
Washington, D.C. 20423

OFFICE OF THE CHAIRMAN

October 16, 1980

Mr. D. L. Scantlebury
Director
Division of Financial and
General Management Studies
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Scantlebury:

This responds to your September 17, 1980 request for written comments on the General Accounting Office (GAO) draft report on "Accounting Changes Needed in the Railroad Industry."

The draft report recommended the Interstate Commerce Commission (1) complete the October 1978 Advance Notice of Proposed Rulemaking and adopt depreciation accounting for track structures; and (2) coordinate future changes in deferred maintenance reporting requirements with the Securities and Exchange Commission (SEC) to guard against conflicting requirements being placed on the railroad industry. The draft report concludes that the SEC and ICC are delaying the adoption of depreciation accounting for track structures because of the probable increase in Federal income taxes. The draft report contends that financial accounting and tax accounting are separate issues and financial accounting should not be judged in light of tax consequences.

We agree that tax consequences should not control financial accounting. In the past, the ICC has generally followed a policy of adopting accounting regulations which meet our regulatory needs regardless of their tax impact. The ICC has not and would not adopt accounting changes solely because they are beneficial to railroads for tax purposes. However, we believe that there are occasional instances where the tax impact is great enough so that the benefit of a rule change should be considered in view of the tax impact. A change to depreciation accounting for track structures is such an instance. We believe adoption of depreciation accounting for track structures for tax purposes will extract a cost from railroads which could undermine the financial stability of even the healthiest of railroads.

Tax legislation was introduced in Congress which would formally adopt betterment accounting for tax purposes. Without this legislation everyone agrees that railroad Federal income taxes would increase which could adversely affect the railroad industry. Originally, the Department of the Treasury (Treasury) disagreed with the proposed tax legislation.

As the draft report points out, Treasury has submitted an alternative proposal to Congress which would allow additional deductions during a transition period to minimize the impact on railroads. However, we believe the Association of American Railroads' (AAR) study shows the tax increase would still be substantial even if Treasury's proposal were adopted. In fact, the failure to include anticipated inflation in the industry study understates the actual industry tax increase. Treasury has now conceded that taxes would increase and has withdrawn its objection to the proposed legislation.

Unlike most property, track cannot be used as collateral for loans to replace track components. Track replacements must be funded from internal operations. The loss of tax benefits of betterment accounting depletes resources available for track replacements. Where a cash shortage occurs, track maintenance is usually deferred. As the draft report points out, deferred maintenance can adversely affect operating efficiency, earnings and future prospects.

At present, we believe the increased Federal income taxes to railroads is too costly a price to pay for the benefits that will accrue to financial statement users from depreciation accounting for track structures. The Financial Accounting Standards Board in Statement of Financial Concepts No. 2 (Paragraph 135) states, "...a standard-setting authority must concern itself with the perceived costs and benefits to both users and preparers of such information, to others, like auditors, who are concerned with it, and to anyone else in society who may be affected." We have assessed the costs and benefits and have chosen to await resolution of the tax issue. When that occurs we will gladly continue with the proceeding to consider adoption of depreciation accounting for track structures.

We agree with the recommendation that the Commission should coordinate changes in deferred maintenance reporting with the SEC. We have followed this policy in the past and we intend to continue.

Thank you for this opportunity to comment on the draft report.

Sincerely yours,

Darius W. Gaskins Jr.

Darius W. Gaskins, Jr.
Chairman

OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OCT 17 1980

Mr. D. L. Scantlebury
Director
Division of Financial and
General Management Studies
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Scantlebury:

Your letter of September 17, 1980 transmitted copies of your draft report, "Accounting Changes Needed in the Railroad Industry," for our review. These comments concern the two proposed recommendations of the draft which apply to this Commission.

RECOMMENDATION: Complete the April 1977, Advance Notice of Proposed Rulemaking on railroad accounting by adopting depreciation accounting for track structures.

We agree with the basic conclusion of your report that, in general, depreciation accounting is a more effective measurement technique than betterment accounting because it systematically allocates the cost of capital assets over their estimated lives. In recent years, however, the effect of changing prices has somewhat diminished the value of cost-based historical financial statements, particularly in industries with large amounts of fixed assets such as railroads. In addition, railroads have been using betterment accounting for many years and investors, analysts and other users of their financial statements understand and make appropriate allowances for its effect. For these reasons, we do not agree that a change to depreciation accounting would so improve the financial statement presentation that other considerations should be disregarded.

Changing from betterment to depreciation accounting would not generate any additional funds, although it would usually increase net income (or reduce net loss) and stockholders' equity. During the last few years this change has been attractive to some unprofitable or marginally profitable railroads which have obtained funds under provisions of the Railroad Revitalization and Regulatory Reform Act of 1976 to accomplish track maintenance and improvement which could not be financed out of funds generated from current operations. Under betterment accounting track maintenance of this type is charged to operating expenses, thereby reducing net income of the current year or increasing a net loss. Under depreciation accounting, substantial portions of track maintenance work can be capitalized and charged to future years operations as depreciation expense so that current year's operations are not adversely affected. The five roads which have adopted depreciation accounting were all unprofitable or marginally profitable.

The Interstate Commerce Commission has a great deal of technical expertise in this area and is actively considering the merits of a change. Under the circumstances, we have deferred taking action pending completion of the ICC's study of the matter in order that railroads and users of financial statements would not be burdened with two methods of reporting for fixed assets. However, if the ICC is unable to resolve this matter on a timely basis, the Commission will address the issue.

RECOMMENDATION: Complete the study of deferred maintenance reporting covered by the April 1977, Advance Notice of Proposed Rulemaking, and require railroads to report deferred maintenance information which fulfills Commission needs yet does not conflict with Interstate Commerce Commission's requirements.

We believe that because there is no widely accepted definition, meaningful reporting of deferred maintenance cannot practically be obtained. Nevertheless, a reasonable alternative solution to the problem may lie in obtaining statistical disclosure of maintenance work performed over a period of years. This information can be provided by schedules based in part on those adopted by the ICC for regulatory reporting purposes, but modified to a form more appropriate for stockholder reporting purposes. Comparison of maintenance work performed over a period of years to a railroad's statistical profile should enable users of the statements to evaluate the extent of work performed. Additional information which might be useful would be a discussion of the track structure and traffic levels and a projection of maintenance to be performed in the current year.

Although the ICC adopted a requirement of this nature some time ago, we have deferred making such a proposal until such time as it can be coordinated with a proposal relating to track structure accounting.

CONCLUSION: It is our understanding that discussions have taken place between staffs of the Congress, the Department of the

Treasury, the Internal Revenue Service, and the ICC regarding the effects of a change in accounting method. We believe that it would be premature for this Commission to consider instituting rulemaking proceedings in this area at this time. Accordingly, we suggest that the two proposed recommendations be revised to state that the Commissioners of the Securities and Exchange Commission should:

> Complete the April, 1977, Advance Notice of Proposed Rulemaking on railroad accounting by proposing amendment of financial statement requirements on a timely basis.

> Complete the consideration of deferred maintenance reporting covered by the April, 1977, Advance Notice of Proposed Rulemaking and consider proposing disclosure guidelines to require railroads to report appropriate statistical information concerning maintenance work performed in recent years in a form which does not conflict with Interstate Commerce Commission requirements.

We thank you for the opportunity to comment on the draft report.

Sincerely,

Harold M. Williams
Chairman

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

OCT 24 1980

Dear Mr. Scantlebury:

We would like to comment on the draft of the GAO report on "Accounting Changes Needed in the Railroad Industry" which you sent us on September 17, 1980. Since the report does not direct any recommendations to the Treasury Department, we do not have any specific comments regarding the recommendations included in the draft report. However, we concur with the conclusion of the report that ratable depreciation accounting for track structure would provide a better measure of a railroad's operating costs than current practices. While we have no comment as to whether, as you recommend, ratable depreciation should be adopted for financial and regulatory purposes, we believe ratable depreciation should be adopted for tax purposes.

As the GAO draft report states, Treasury testified before Congress on September 27, 1979 and October 22, 1979 in opposition to proposed legislation (H.R. 4446 and S. 1467) supported by the railroads that would codify in the Internal Revenue Code the retirement-replacement-betterment (RRB) method of depreciation accounting used by railroads. As the GAO draft report states, we do not believe that the use of the RRB method is appropriate for tax purposes because (1) it does not clearly reflect income, (2) it is, in effect, indexation of depreciation which is not available to other taxpayers, (3) it is subject to various abuses, and (4) its continued use would be burdensome for the IRS to administer. We attempted to resolve the conflict between our position and the position of the railroads that the change to ratable depreciataion would be too costly. We proposed possible treatments of the change to ratable depreciation that would minimize the additional tax cost during a transition period. However, no proposal was agreed to. During the markup of H.R. 4446 by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in May, 1980, Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation, stated our position as follows:

APPENDIX IV

"We had suggested that the committee delay looking at this subject until it looked at depreciation generally. If that were not possible we had suggested that there be an alternative method which would be more rational and which would avoid administrative problems of RRB and which would be an explicit indication of what was being done here for this industry. We have detected a certain lack of enthusiasm. We have talked to the ICC about the possibility of their continuing to require RRB reporting in the alternative as well as whatever new method they might require so that there would be some check on people, besides the tax return, on the use of this method.

We have had some indications that they are willing to do so. On that assumption and on the further understanding that we assume everybody agrees that if Congress were to take a further look at depreciation in the future that this matter would be reconsidered in that context, on those assumptions we are prepared to reduce our level of objections to this bill.

On September 15, 1980, the Senate Finance Committee reported out H.R. 5829, the "Tax Reduction Act of 1980." This bill includes major amendments to the Internal Revenue Code involving depreciation which would substantially increase the amount of depreciation deductions allowed taxpayers and would simplify depreciation methods. On August 28, 1980, President Carter announced the Administration's Constant Rate Depreciation proposal for substantially increasing depreciation allowances and simplifying depreciation computation methods. While we do not expect any action to be taken with respect to depreciation legislation during the remainder of the 96th Congress, we expect that depreciation legislation will be considered in the 97th Congress. As we stated to the Subcommittee on Select Revenue Measures in May, 1980, we believe that when Congress considers depreciation legislation, it should also consider the use of the RRB method. Since we made that statement last May, Congress has started its consideration of depreciation legislation, and we believe no further action should be taken regarding the proposal to codify the RRB method. To the contrary, we believe that <u>all</u> assets of railroads should be included in the proposed Constant Rate Depreciation system which the administration has proposed, including assets now accounted for under the RRB method. A change to ratable depreciation from the RRB method can be made at the time that depreciation allowances are increased with <u>no</u> tax increase to any railroad, but in fact a significant tax decrease. Therefore, the reason cited by the railroads for retaining RRB (the increased tax) would not exist. However, until Congress has had an opportunity to consider general depreciation legislation we would not favor any administrative action regarding RRB.

We strongly recommend that the GAO final report include a recommendation that all railroad assets be included in any new tax depreciation system passed by Congress and that RRB be no longer available for tax purposes.

Sincerely,

Donald C. Lubick

Donald C. Lubick
Assistant Secretary
(Tax Policy)

Mr. D.L. Scantlebury
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Enclosures

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