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Betterment Accounting: A Requiem by the SEC

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ACCOUNTING—BETTERMENT ACCOUNTING: A REQUIEM BY THE SEC?

The railroad industry, unlike almost every other industry, has a depreciation accounting system all its own known as betterment accounting. In sharp contrast to generally-accepted methods of depreciation, such as ratable depreciation, where the cost of the capital asset is systematically expensed over the useful life of the asset,[1] under the betterment practice, the initial cost of track structures is recorded as a nondepreciable asset.[2] Subsequent replacement costs are then charged directly to operating expense as an "adequately reliable" measure of depreciation.[3]

Justifications for this unique system of accounting relate primarily to the peculiar nature of railroad track structure—a large number of individual components that can be replaced on a scheduled basis.[4] The American Institute of Certified Public Accountants, noting the historical acceptance of betterment accounting,[5] continues to allow the betterment method in railroad financial reports to shareholders.[6] The Interstate Commerce Commission (ICC) has grappled constantly with the issue since the agency was formed in 1887,[7] but still finds the betterment method

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1. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING TERMINOLOGY BULLETIN NO. 1 ¶ 56 (Aug. 1953). For example, the yearly depreciation charge for a track segment initially costing $10,000 with a useful life of ten years would be $1,000 ($10,000/10) using the straight-line method of ratable depreciation.

2. SEC Securities Act Release No. 5824 [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,135, at 87,903 (Apr. 28, 1977). In this release, the Securities and Exchange Commission (SEC) announced it was considering the formulation of rules and guidelines with respect to the form and content of railroad industry disclosure standards, uniform definitions and standards for deferred maintenance and its quantification, and the appropriateness of betterment accounting in documents filed with the SEC. *Id.* at 87,901. In addition, the SEC invited public comment regarding these topics. *Id.* This article is based substantially on the public comments filed with the SEC. The letters cited herein are on file in SEC Public Comment File S7-692. A copy of this file is located at the Journal of Corporation Law office.

3. At least at its inception, betterment accounting was felt to be an adequately reliable measure of depreciation. Letter from Southern Pacific Transportation Company to George Fitzsimmons, Secretary, SEC, at 1 (Sept. 15, 1977) (unpublished letter in SEC Public Comment File S7-692). Using the example in note 1 *supra*, assuming constant prices and regular replacement, 10% of the track would be replaced each year, resulting in the same $1,000 annual charge to depreciation under the betterment method.

4. Seder, *Accounting for the Railroad Industry*, HANDBOOK OF ACCOUNTING METHODS 806 at 808-09 (3d ed. L. Gray, B. Greisman & T. Lasser 1964). The nature of railroad track structure may not be so unique so as to require its own accounting system. Owners of vehicle fleets, for example, may have a large number of units, a certain number of which will require replacement each year. Letter from Financial Analysts Federation to George Fitzsimmons, Secretary, SEC, at 10 (dissenting opinion) (Sept. 16, 1977) (unpublished letter in SEC Public Comment File S7-692).

5. A committee of the American Institute of Certified Public Accountants stated in 1957 "a practice consistently followed for more than 50 years and which affects a significant segment of the railroads' properties and operations should not be changed unless and until it has been found to be clearly erroneous by a convincing preponderance of evidence." Reply of the Committee of the Institute of Certified Public Accountants to Mr. Owen Clarke, Chairman, ICC, (Dec. 31, 1957), published in INTERSTATE COMMERCE COMMISSION, UNIFORM SYSTEM OF ACCOUNTS FOR RAILROAD COMPANIES: BETTERMENT AND DEPRECIATION ACCOUNTING, RAILROADS, 309 I.C.C. 289 at 293 (1959).

6. *Id.*

7. Betterment accounting was initially prescribed by the ICC in 1914 in its Uniform System of Accounts. But in 1926 and 1931, depreciation accounting was ordered for track structures. Neither order was ever implemented and in 1942 track accounts were omitted from depreciable property. The

acceptable and even requires it in railroad reports submitted to the Commission.[8]

The Securities and Exchange Commission (SEC) has a chance to make a fresh, critical examination of the appropriateness of betterment accounting for shareholder reporting purposes. The Railroad Revitalization and Regulatory Reform Act of 1976[9] [4R Act] gives the SEC expanded authority to issue disclosure requirements for railroads in filings with the SEC and reports to investors.[10] Pursuant to this grant of authority, the SEC in April of 1977 announced a proposed rulemaking to examine the standards for disclosure of railroad industry operations.[11] The SEC requested public comment as to whether betterment accounting should continue to be an acceptable accounting principle for railroads for reporting their financial position and results of operations to shareholders and the SEC.[12]

The betterment method and the alternative ratable depreciation approach must be compared in light of the SEC's role in ensuring proper disclosure of financial information to the public: which method yields a more accurate picture of a railroad's operating results and over-all financial health? This article will closely examine these two accounting methods by reviewing the public comment received by the SEC under its rulemaking procedure. First the betterment method currently practiced by railroads will be discussed, followed by an analysis of the more widely-accepted ratable depreciation approach.

THE CURRENT BETTERMENT METHOD

Traditional Justifications

The betterment approach to railroad accounting has strong historical support within the industry. It has been recognized as an acceptable method of accounting since before 1900,[13] and was officially adopted by the ICC in 1914.[14] All but five of

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issue was again confronted in a proposed rulemaking on betterment accounting in 1957, resulting in the ICC confirming its earlier order in 1959. Letter from Arthur Andersen & Co. to George Fitzsimmons, Secretary, SEC, at Exhibit I (June 15, 1977) (unpublished letter in SEC Public Comment File S7-692).

8. Betterment accounting for track structure accounts is included in the current Uniform System of Accounts of the Interstate Commerce Commission. Letter from Santa Fe Industries to George Fitzsimmons, Secretary, SEC, at 18 (Sept. 15, 1977) (unpublished letter in SEC Public Comment File S7-692).

9. Pub. L. No. 94-210, 90 Stat. 31 (1976).

10. The 4R Act required the ICC to establish an accounting system in accordance with generally-accepted accounting principles and the rules of the SEC. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, § 307, 90 Stat. 56 (1976) (to be codified in 49 U.S.C. § 20(3)(c)).

11. SEC Securities Act Release No. 5824, *supra* note 2, at 87,901. The SEC implicitly challenged the practice of betterment accounting in a proceeding against Burlington Northern, Inc., a railroad employing the betterment method in accounting for track structures. The SEC found the reports and public disclosures filed by the Burlington Northern had "not provided adequate information with respect to (1) policies and practices concerning maintenance and capital expenditures for physical plant and equipment and (2) the profitability of its railroad operations." In the Matter of Burlington Northern, Inc., SEC Exchange Act Release No. 13,480 (Apr. 28, 1977), SEC Docket, May 10, 1977 at 234. The SEC further recognized "that deficiencies with respect to disclosures concerning maintenance and capital expenditure practices may not be unique to BNI," and affirmed "the obligation of railroad issuers to make disclosures of the factors affecting charges against come in light of maintenance practices and *the impact of the betterment method*." *Id.* at 238 (emphasis added).

12. *Id.*

13. The practice of betterment accounting dates "back to the very beginning of railroads in the 19th century." Letter from Southern Pacific to SEC, *supra* note 3, at 1. Betterment accounting has also received judicial approval. In Southern Ry. Co. v. Commissioner, 74 F.2d 887 (1935), the Fourth Circuit Court of Appeals said:

> It would be inconvenient, if not impractical in railroad accounting to charge every item having a life of more than one year to capital account and allow depreciation on it as a deductible item

America's largest railroads[15] use the betterment method today in reports to shareholders.[16]

Before an accounting method can be deemed acceptable under current reporting standards, however, the traditional justifications on which the method is based must be compared to the conditions presently existing in the railroad industry.[17] Quality of information should be of greater concern than tradition, and where changed conditions in both the economy and the industry itself have made an accounting approach obsolete, tradition alone cannot compel its continued use.

Betterment accounting was originally designed to reflect several unique operating features of railroads: (1) adequate and continuous replacement of track components, (2) minor changes in the physical quantity of track structure, and (3) the absence of technological obsolescence.[18]

None of these unique operating features, however, is present in today's railroad industry. Instead of continuous replacement of track components, studies show that during the 1950's and 1960's track structure was not maintained at an adequate level,[19] resulting in current estimates of deferred maintenance exceeding seven bil-

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> of expense; and in a great business where thousands of similar replacement or repair items are involved nothing would be gained by such a system of accounting, since, on the law of averages, expenditures for such items during a given year would substantially balance the depreciation for that year. The proper accounting practice, therefore, is to allow normal expenditures for repairs and replacements as an expense of the business and not to allow depreciation on such items except to the extent that it may not be covered by expenditures for repairs and replacements.

74 F.2d at 890.

14. *See* note 7 *supra*.

15. The largest railroads being the Class I railroads as defined by the ICC.

16. Four railroads which have adopted ratable depreciation accounting for track structure are the Chicago & Northwestern, the Rock Island, Conrail, and Illinois Central Gulf. Letter from Missouri Pacific Railroad Company to George Fitzsimmons, Secretary, SEC, at 4 (Aug. 25, 1977) (unpublished letter in SEC Public Comment File S7-692). Additionally, Chicago Milwaukee changed from betterment to ratable depreciation accounting as of the third quarter of 1977. Wall St. J., Nov. 7, 1977, at 13, col. 2.

17. The SEC made this observation in In the Matter of Burlington Northern, Inc., *supra* note 11 at 238. ". . . [T]he Commission is concerned that adjustments in accounting treatment may be necessary if the conditions supporting the use of betterment accounting have changed."

A re-examination of railroad accounting is especially appropriate when the history of the past few years in the accounting profession is considered. Efforts have been made to eliminate abuses present in financial reporting. Letter from Financial Analysts Federation, *supra* note 4, at 10 (dissenting opinion). Examples of such reforms include FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 13 (Nov. 1976) (restricting off-balance sheet leasing); FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 8 (Oct. 1975) (requiring the translation of foreign currency transactions); FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 5 (March 1975) (setting guidelines for reporting contingencies); FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 2 (Oct. 1974) (requiring the expensing of research and development expenditures).

18. Letter from Price Waterhouse & Co. to George Fitzsimmons, Secretary, SEC, at 6 (Sept. 14, 1977) (unpublished letter in SEC Public Comment File S7-692).

19. THE AMERICAN RAILROAD INDUSTRY: A PROSPECTUS, AMERICA'S SOUND TRANSPORTATION REVIEW ORGANIZATION (June 1970), noted in SEC Securities Act Release No. 5824, supra note 2, at 87,902. In the case of Burlington Northern, Inc., for example, "since about 1958, the average annual levels of BNI's rail and tie replacements have been at approximately one half the levels prevailing in the 1940's and 1950's." In the Matter of Burlington Northern, Inc., supra note 11, at 235.

Absent regular replacement of track components, betterment accounting projects a distroted pricture of a railroad's financial condition. The ICC implicitly requires adequate replacement of track structure in its endorsement of the betterment method.

> As long as railroads continue to maintain existing track in proper condition through adequate replacement, as needed, of rails, ties, ballast, and other material, so that deterioration in track structure and impariment of the corporation's capital investment is avoided, no good purpose

lion dollars.[20] The physical quantity of track structure has not remained constant, but has declined due to widespread abandonment of uneconomical lines.[21] In addition, economic and technological obsolescence is becoming a major problem for railroads as quality of service declines and other forms of transportation become more competitive.[22]

Comparability and Credibility of Financial Statements

The railroad industry's continued use of betterment accounting may contribute to its inability to raise sufficient investment capital. Because the railroad industry is the only industry employing the betterment method,[23] and even then only for track structures,[24] the financial statements of railroads are not comparable with those of other enterprises.[25] The efficient allocation of capital requires that all security-issuers compete on the same basis.[26] To the extent that investors are unable to conveniently weigh the attractiveness of alternative investments due to the use of hybrid accounting techniques, railroads will be deprived of badly-needed investment capital.[27]

Railroads are also hurt in the capital markets because of the confusion that betterment accounting creates in the minds of financial statement users.[28] The readability and credibility of financial statements are absolutely essential for any company seeking to raise money through public issue or private placement.[29] The credibility of a railroad's financial statements can surely not be helped when its major asset, track structure, is depreciated according to a method understood by only a small proportion of financial statement users.[30]

Relation to Generally-Accepted Accounting Principles

The betterment system of accounting contrasts sharply with the generally-accepted methods of defining and calculating depreciation.[31] Under the betterment

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> would be served by changing the long-established existing accounting rules and requiring retirement and depreciation accounting for such property.

ICC Uniform System of Accounts, *supra* note 5, at 296.

20. Thomas K. Dyer, Inc., *Maintenance of Way Study, United States Class I Railroads*, ASSOCIATION OF AMERICAN RAILROADS (Oct. 1974), noted in SEC Securities Act Release No. 5824, *supra* note 2 at 87,902.

21. 4,740 miles of track are currently up for abandonment proceedings before the Interstate Commerce Commission and Class I railroads anticipate the abandonment of 7,944 more miles of line within the next three years. RAILWAY AGE, May 30, 1977, at 10.

22. AMERICAN RAILROAD INDUSTRY: A PROSPECTUS, *supra* note 19.

23. SEC Securities Act Release No. 5824, *supra* note 2, at 87,904.

24. *Id.*

25. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion).

26. *Id.* Investment capital will find its way to companies earning the highest rates of return at a given level of risk. That process is distorted when profit figures are computed using a variety of accounting techniques.

27. *See* Comments of the U.S. Department of Transportation before the SEC at 20 (Sept. 16, 1977) (unpublished letter in SEC Public Comment File S7-692).

28. *Id.* Proponents of betterment accounting argue, however, the method is "recognized and accepted by the financial community and is understood by securities analysts and investment advisors." Letter from Southern Railway System to George Fitzsimmons, Secretary, SEC, at 2 (Sept. 15, 1977) (unpublished letter in SEC Public Comment File S7-692).

29. Letter from Kuhn Loeb & Co. to George Fitzsimmons, Secretary, SEC, at 2 (Sept. 9, 1977) (unpublished letter in SEC Public Comment File S7-692).

30. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion).

31. It is uncertain whether betterment accounting has the blessing of the accounting profession as a

method, the

> entire initial cost of the track materials and labor installation is capitalized and such costs are not depreciated. Instead, as individual items comprising the track system are replaced, i.e., rails, ties, ballast, and other track materials, the cost of replacement in kind is charged against income, and only the cost of betterments (e.g., heavier grade rail installed in replacement of lighter rail) is capitalized. When property is retired without being replaced—which only occurs when rail lines are abandoned—its entire carrying value, less salvage, is charged against income.[32]

The betterment method as practiced under current conditions is inconsistent with generally-accepted accounting principles in that it (1) fails to uniformly measure the consumption of capital investments, (2) violates the matching concept of accounting, (3) does not provide for a systematic and rational allocation of costs of capital assets, and (4) does not recognize the finite nature of the useful life of railroad track structure.

The betterment approach does not properly distinguish between costs that should be capitalized and ordinary business expenses.[33] In contrast to the ratable depreciation method, where major maintenance is capitalized and minor maintenance is expensed,[34] under the betterment method, both the replacement of major capital assets and minor maintenance are combined under the single accounting category of maintenance.[35] As a result, the betterment method fails to uniformly recognize the cost of capital consumed in operations.[36]

The betterment approach seeks to compensate for the unrecorded depreciation by charging the replacements as operating expenses.[37] Under circumstances of stable prices and replacement on a regular, even basis, the results under the betterment and ratable depreciation methods would be roughly equal.[38] But neither condition is present in the industry today. Current maintenance and replacement levels are grossly inadequate,[39] and absent replacement on a regular, even basis, under the betterment method the reported capital consumption of track structures as a cost of service will be similarly inadequate.[40]

The matching concept of generally-accepted accounting principles is also vio-

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generally-accepted accounting principle for railroad industry operations. The issue was last considered in 1966, and the American Institute of Certified Public Accountants committee was unable to resolve the question. Letter from Arthur Andersen & Co., *supra* note 7, at 2.

32. Letter from Santa Fe Industries, *supra* note 8, at 19.

33. Letter from Arthur Andersen & Co., *supra* note 7, at 2-3.

34. Reply comments of the U.S. Department of Transportation before the ICC, at 16-17 (June 1, 1977) (unpublished letter in SEC Public Comment File S7-692).

35. Comments of the Department of Transportation before the SEC, *supra* note 27, at 20.

36. Letter from Arthur Andersen & Co., *supra* note 7, at 2.

37. *Id.* at 3.

38. *See* Letter from Association of American Railroads to George Fitzsimmons, Secretary, SEC, at 20 (Sept. 16, 1977) (unpublished letter in SEC Public Comment File S7-692). Assuming an initial cost of $100,000 and a useful life of 20 years, the annual straight-line depreciation cost would be $5,000. Under the betterment method, with stable prices and regular replacement, 5% of the track structure would be replaced each year, and the same $5,000 figure results.

39. *See* text accompanying note 20 *supra*.

40. Using the example, *supra* note 38, replacement of 5% of the track structure each year would yield an adequately reliable measure of capital consumption costs. Once this replacement rate drops to 2%, for example, the costs of capital asset consumption become grossly understated.

According to the SEC, ". . . [O]ne of the assumptions underlying betterment accounting is that the track structure will be maintained at a relatively constant level and will not be permitted to deteriorate." In the Matter of Burlington Northern, Inc., *supra* note 11, at 236.

lated under the betterment approach.[41] The matching concept requires that the cost of capital expenditures which benefit future periods be recorded as a capital asset and amortized over the expected period of benefit.[42] Under the betterment method, the maintenance expenses charged against current income include not only minor maintenance items, but also the replacement of major capital assets.[43] Because these capital assets will benefit future periods, to expense such expenditures represents an obvious violation of the matching principle.

The method of cost allocation under betterment accounting is not systematic and rational, as required under generally-accepted methods of depreciation.[44] Under ratable depreciation, the costs of the track structure are allocated over future periods in amounts approximating "the diminished utility of the asset resulting from either physical deterioration or economic obsolescence."[45] In contrast, under the betterment method, the cost of capital consumption has no bearing whatsoever to actual use of the asset, but depends instead on the replacement program undertaken by the particular railroad,[46] which varies according to the particular needs of railroad management.[47]

Betterment accounting ignores the fact that railroad track structures have a finite economic life.[48] By recording the structures as nondepreciable assets, the betterment method presumes perpetual economic value.[49] In fact, railway track structures may become obsolete through changes in the economies of service areas and increased competition from other modes of transportation.[50] Under betterment accounting, track structures which are physically operative are still carried on the books, even though the line may be economically obsolete.[51]

Manipulation of Earnings

The use of betterment accounting creates an incentive for railroad management to defer maintenance in order to manipulate the level of earnings. Under the betterment approach, the capital asset costs are expensed only when the replacement of the asset occurs.[52] There is no fixed charge each year as under ratable depreciation.[53] Thus by postponing asset replacement in less prosperous times, which decreases maintenance expense, and increasing asset replacement in profitable years, earnings swings typical of the railroad industry can be smoothed out.[54]

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41. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion).
42. *Id.*
43. Comments of the Department of Transportation before the SEC, *supra* note 27, at 20.
44. Depreciation accounting distributes the cost of "tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner." ACCOUNTING TERMINOLOGY BULLETIN NO. 1, *supra* note 1, at ¶ 56.
45. Letter from Santa Fe Industries, *supra* note 8, at 22.
46. Letter from Arthur Andersen & Co., *supra* note 7, at 3.
47. *See* text accompanying notes 52-58 *infra*.
48. Letter from Coopers & Lybrand to George Fitzsimmons, Secretary, SEC at 3 (Sept. 19, 1977) (unpublished letter in SEC Public Comment File S7-692).
49. Letter from Arthur Andersen & Co., *supra* note 7, at 3.
50. Letter from Coopers & Lybrand, *supra* note 48, at 3.
51. Letter from Arthur Andersen & Co., *supra* note 7, at 3.
52. Comments of the Department of Transportation before the SEC, *supra* note 27, at 21.
53. Ratable depreciation expenses a portion of the capitalized value of the asset each year until the salvage value is reached. ACCOUNTING TERMINOLOGY BULLETIN NO. 1, *supra* note 1, at ¶ 56.
54. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion). The direct effect of maintenance expenditures on current income under the betterment method was noted by the SEC in the proceeding against the Burlington railroad. "Management decisions to increase or decrease

Financial accounting should portray as accurate a picture as possible.[55] While railroad management may react favorably to the flattening out of otherwise volatile earnings,[56] a government agency concerned with adequate disclosure to investors will likely not encourage the further use of an accounting method capable of giving this false image of stability.

Betterment accounting can also be used by railroad management to systematically inflate earnings by underspending for the maintenance of track structures.[57] The replacement of the asset is simply deferred beyond a prudent time, thus decreasing maintenance expenses for years in which the replacement is deferred.[58]

This is not to suggest that the vast amounts of deferred maintenance[59] present today in America's rail system are due to the income-inflating potential of betterment accounting. Clearly other considerations enter into setting the level of roadbed-maintenance expenditures, such as cash flow[60] and the needs of the shipping community.[61] But it is also clear that betterment accounting does create an incentive for management to defer maintenance, with the resulting deferral contributing to the deterioration of both the nation's rail system[62] and the credibility of railroad financial statements.[63] By abolishing betterment accounting in reports to shareholders, the SEC would destroy this income-inflating device.

Betterment accounting also influences management to postpone recognizing the obsolescence of miles of track structure.[64] Because costs of utilizing property never replaced are not recognized until retirement under the betterment approach,[65] railroad management will have an incentive to preserve as "in service" lines that are actually abandoned by economic standards.[66] The result on the financial statements is an overstatement of asset and equity values.[67]

(or not to increase) track replacement programs have a different and more immediate impace on current reported earning than do similar decisions with respect to other capital programs." In the Matter of Burlington Northern, Inc., *supra* note 11, at 235-36.

55. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion).

56. Because of the high leverage ratios of the railroad industry, both in terms of capitalization and operating characteristics, railroad management attempts to flatten earnings fluctuations to preserve coverage ratios and current returns on invested capital. *Id.* at 6.

57. *Id.* For example, in September of 1973, the Board of Directors of Burlington Northern, Inc. was informed by management that new rail replacement levels for 1974 were going to held down "in order to achieve a satisfactory level of earnings." In the Matter of Burlington Northern, Inc., *supra* note 11, at 235.

58. Comments of the Department of Transportation before the SEC, *supra* note 27, at 21. By increasing income through the deferral of maintenance, there is the added danger that dividends are paid from income "created by the firm's failure to provide for the replacement of its physical assets." *Id.* at 22.

59. *See* text accompanying note 20 *supra*.

60. Letter from Chessie System to George Fitzsimmons, Secretary, SEC, at 2 (Sept. 5, 1977) (unpublished letter in SEC Public Comment File S7-692); letter from Price Waterhouse & Co., *supra* note 18, at 6; letter from Southern Railway System, *supra* note 28, at 2.

61. Letter from Missouri Pacific Railroad, *supra* note 16, at 1.

62. SEC Securities Act Release No. 5824, *supra* note 2, at 87,904.

63. *Id.*

64. Letter from Arthur Andersen & Co., *supra* note 7, at 3.

65. *Id.*

66. The extent to which railroad management can be blamed for the current deferral of track abandonments may be very limited. Delays caused by federal and state regulatory agencies played a prominent part in preventing railroads from writing obsolete facilities off the books. Letter from Kuhn Loeb & Co., *supra* note 29, at 3.

67. "The original cost of the track structure remains on the balance sheet even though the service

Effects of Inflation

One advantage of betterment accounting is its ability to allow for the effects of inflation in the earnings of a company.[68] In contrast to ratable depreciation, where the cost of capital consumption is based on the *historical* cost of the asset,[69] under the betterment method, the replacements charged against income are based on *current* cost.[70] Railroads are thus charged with an actual inflation factor reflecting the cost of track replacement.[71] This practice is especially noteworthy in light of the recent trend in the accounting profession toward allowing for the impact of inflation on financial reports.[72]

But any advantage of an accounting system that properly adjusts for inflation is discounted when all other business enterprises allocate costs based on a historical basis.[73] In order to provide for uniformity in financial reporting, adjustments for inflation must be made on a broad basis for all industries, not on a piecemeal, industry-by-industry apporach.[74] Financial statements are most valuable when they can be easily compared to businesses in other industries.[75]

The Alternative Ratable Depreciation Approach

Increased Information to Investors

The adoption of ratable depreciation by railroads in accounting for their track structure would result in a more accurate presentation of financial position and operating results than is currently offered under betterment accounting. Ratable depreciation accounting would benefit the investor by (1) making railroad financial statements comparable with those of other industries, (2) recognizing costs of railroad operations that go unrecognized under the betterment approach, and (3) eliminating the abuses possible through betterment accounting.

First, by accounting for track structures under a ratable depreciation approach,

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life has declined or the structure is no longer usable." Letter from Coopers & Lybrand, *supra* note 48, at 3.

68. Letter from Association of American Railroads, *supra* note 38, at 19; letter from Price Waterhouse & Co., *supra* note 18, at 6; letter from Santa Fe Industries, *supra* note 8, at 19; letter from the Union Pacific Railroad to George Fitzsimmons, Secretary, SEC, at 3 (Sept. 23, 1977) (unpublished letter in SEC Public Comment File S7-692).

69. Comments of the Department of Transportation before the SEC, *supra* note 27, at 18.

70. *Id.* And the effect is a conservative statement of income, also in line with a major accounting principle. Letter from the Association of American Railroads, *supra* note 38, at 21.

71. Letter from the Southern Railway System, *supra* note 28, at 2. Replacement costs will rise as the price level in the economy rises, in contrast to ratable depreciation, which is based on a constant historical cost figure.

72. The SEC requires the largest reporting corporations to provide footnote disclosure of financial data regarding current replacement costs of certain assets, and the resulting depreciation charge based on these replacement costs. "These proposals were designed to enable investors to obtain more relevant information about the current economics of a business enterprise in an inflationary economy than that provided solely by financial statements prepared on the basis of historical cost." Accounting Series Release No. 190, 41 Fed. Reg. 13596 (1976), reported in 5 FED. SEC. L. REP. (CCH) ¶ 72,212, at 62,504 (1976).

73. Letter from Arthur Andersen & Co., *supra* note 7, at 4.

74. *Id.*

75. "Variations in accounting practices followed by two companies may have more effect on financial comparisons between them than result from differences in the facts and circumstances." ARTHUR ANDERSEN & CO., ESTABLISHING ACCOUNTING PRINCIPLES—A CRISIS IN DECISION MAKING (1965), *reprinted in*, T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 577 (1971).

all railroad property would be treated similarly[76] and under a method used by virtually all other business enterprises.[77] With the adoption of a familiar accounting technique, much of the confusion that currently exists in the minds of investors over railroad accounting practices would be eliminated.[78] The resulting increase in both the comparability and integrity of railroad financial reports would allow railroads to compete in the capital markets on the same basis as other security-issuers.[79]

Second, ratable depreciation accounting specifically recognizes the cost of utilizing capital assets as a cost of doing business.[80] Under the ratable depreciation approach, capital expenditures benefitting future periods are recorded as assets and are systematically expensed over the expected period of benefit,[81] the useful life of the asset. By doing this, ratable depreciation clearly shows the cost of gradual expiration of capital assets as an operating expense of the period, regardless of the amount of maintenance work performed on the track structures during the period. Betterment accounting, on the other hand, expenses the cost of the capital asset in the period in which the replacement of the asset occurs.[82] Measurement of capital consumption costs is thus dependent on regular, even replacement. In a period in which no major maintenance is performed, betterment accounting would recognize no cost of capital consumption.[83]

Ratable depreciation adds further to the clarification of costs of operation by separating the costs of capital recovery, or depreciation expense, from normal maintenance expense.[84] In contrast to the betterment method, where maintenance expense for a given period includes both the replacement of capital assets and minor maintenance,[85] ratable depreciation would capitalize the cost of any major maintenance work performed, while routine maintenance would still be expensed.[86] Ratable depreciation thus enables the investor to ascertain the amount of capital replacement undertaken by the railroad in a particular period.[87]

Railroad managements would have no incentive to defer maintenance as a means of inflating or averaging income under ratable depreciation accounting.[88] Instead of the capital asset replacement being expensed entirely in the period of

76. Currently, track structure is the only railroad property costed under the betterment method. *See* text accompanying note 24 *supra*.

77. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion).

78. *See* note 28 *supra* and accompanying text.

79. Letter from Financial Analysts Federation, *supra* note 4, at 9 (dissenting opinion).

80. Letter from Arthur Andersen & Co., *supra* note 7, at 2.

81. *See* note 1 *supra*.

82. Comments of the Department of Transportation before the SEC, *supra* note 27, at 21.

83. Letter from Arthur Andersen & Co., *supra* note 7, at 3.

84. Comments of the Department of Transportation before the SEC, *supra* note 27, at 20-21.

85. *See* note 35 *supra* and accompanying text.

86. *See* note 34 *supra* and accompanying text.

87. Comments of the Department of Transportation before the SEC, *supra* note 27, at 21.

88. With the adoption of ratable depreciation accounting, railroads which appear marginally profitable through continued maintenance deferrals will appear less profitable. The resulting financial picture, however, is much more accurate due to the elimination of the distortions of betterment accounting. Comments of the Department of Transportation before the SEC, *supra* note 27, at 25. In addition, a change to ratable depreciation accounting will help railroads with large amounts of deferred maintenance since costs of major rehabilitative efforts in the future will be capitalized and amortized over the later periods which benefit from the maintenance. Under betterment accounting, however, immediate expensing of such major maintenance programs would cause depressed earnings. Letter from Conrail to George Fitzsimmons, Secretary, SEC, at 3 (Sept. 16, 1977) (unpublished letter in SEC Public Comment File S7-692).

replacement,[89] ratable depreciation requires a gradual expensing of the capitalized value of the asset each year over its useful life.[90] Depreciation accounting is thus less sensitive to changes in maintenance patterns,[91] and depreciation expense is taken out of the realm of management discretion.[92]

Implementation Problems

Ratable depreciation accounting is defined as "a system of accounting which aims to distribute the cost . . . of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner."[93] Before this accounting methodology can be applied effectively to a railroad track structure,[94] fundamental issues relating to the definition of factors in the depreciation formula must be resolved.

A major hurdle is the revaluation of the track structure as recorded on the current balance sheets.[95] Track structure is currently carried at historic cost, with adjustments for subsequent betterments.[96] Since there is no connection between these figures and the current replacement cost of that trackage,[97] a one-time revaluation will be necessary to more accurately reflect current economic conditions.[98] Depreciation based on the historic asset values would be far too low, resulting in the overstatement of income.[99]

Railway property must be defined into units of property appropriate for use as a basis of depreciation.[100] This process of defining is central to the ratable depreciation approach since it serves to differentiate capital expenditures from operating expenses.[101] If the unit of property employed is too small, almost all of the annual track account expenditures would be capitalized and amortized over the useful life of the asset,[102] resulting in large increases in earnings even though cash flow is unchanged.[103]

Theoretically, the unit of property could range from a single railroad tie to an entire track structure, with the resulting impact on income varying just as widely.[104]

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89. *See* note 52 *supra* and accompanying text.
90. *See* note 1 *supra* and accompanying text.
91. Letter from Union Pacific Railroad, *supra* note 68, at 3.
92. Comments of the Department of Transportation before the SEC, *supra* note 27, at 21.
93. ACCOUNTING TERMINOLOGY BULLETIN NO. 1, *supra* note 1, at ¶ 56.
94. The betterment method is used by railroads only in accounting for track structures. *See* note 24 *supra* and accompanying text.
95. Letter from ICC to George Fitzsimmons, Secretary, SEC, at 7 (June 17, 1977) (unpublished letter in SEC Public Comment File S7-692); letter from Price Waterhouse & Co., *supra* note 18, at 8.
96. Comments of the Department of Transportation before the SEC, *supra* note 27, at 23.
97. *Id.*
98. *Id.*
99. *See* text accompanying notes 121-22 *infra*. The need for the one-time revaluation arises because of the transition costs that would be incurred if depreciation costs under ratable depreciation are much less than those incurred under the betterment method. By revaluing the book value to more accurately reflect replacement cost, charges to income under the two methods would correspond more closely.
100. Letter from Missouri Pacific Railroad, *supra* note 16, at 4; letter from Price Waterhouse & Co., *supra* note 18, at 7; letter from Union Pacific Railroad, *supra* note 68, at 5.
101. Letter from ICC, *supra* note 95, at 6.
102. Letter from Missouri Pacific Railroad, *supra* note 16, at 4.
103. The four railroads that have adopted ratable depreciation in accounting for track structure are using a 1/4 lineal mile of track or similar short measure for a unit of property. Conrail, one of the four, reduced its operating loss by over 100% by the change in methods, even though its cash flow remained unchanged. *Id.*
104. Letter from Union Pacific Railroad, *supra* note 68, at 5.

Only by developing a uniform unit of property that will be followed throughout the railroad industry will the comparability of operating results reported by each railroad be ensured.[105]

Before the ratable depreciation method can be accurately applied to railroad track structure, the service lives of track components must be estimated. Because under the ratable depreciation approach the costs of the asset is gradually expensed over the useful life of the asset,[106] the useful life serves as the basic factor for determining depreciation rates.[107] Estimates of service lives must consider not only the physical expiration of the assets, but the decline in value due to economice obsolescence as well.[108]

Questions concerning the proper salvage value to be subtracted from the cost of the asset being depreciated must also be resolved before ratable depreciation accounting can be implemented.[109] Salvage value is generally determined by the price of railroad scrap.[110] In periods of inflation, coupling overstated salvage figures with understated historic cost of track structures would result in unrealistically low depreciation charges.[111]

Effects on Income

The adoption of ratable depreciation by the railroad industry in accounting for track structures could potentially result in substantial transition costs. The primary transition cost is the increase in income taxes due to higher income figures.[112] While income under the betterment method is stated conservatively since the charges to income are based on current replacement cost,[113] depreciation charges under ratable depreciation accounting, based on lower historic cost,[114] result in higher income figures,[115] assuming equal maintenance expenditures under both methods. Railroads would thus be earning "paper" profits since no corresponding increase in cash flow is realized.[116] Other possible effects of the paper profits are

105. Letter from Missouri Pacific Railroad, *supra* note 16, at 5.

106. *See* text accompanying note 1 *supra*.

107. Letter from Interstate Commerce Commission, *supra* note 95, at 6.

108. *Id.*

109. *Id.* at 7.

110. *Id.*

111. Currently the salvage value of rail in place exceeds the average original cost of the rail. Letter from Price Waterhouse & Co., *supra* note 18, at 8. The resulting low depreciation charges are best illustrated by an example. If a track structure initially costing $100,000 has a useful life of 20 years and consists of component parts that, because of inflation, have a salvage value of $80,000, the appropriate annual depreciation charge would be $1,000 ($100,000-$80,000/20) using the straight-line method. If the cost of replacing the track structure is currently $500,000, the $1,000 annual depreciation charge would be unrealistically low in an economic sense.

112. However, this assumes the Internal Revenue Service will also adopt ratable depreciation accounting for railroad track structure. "The tax method need not follow the method required for financial reporting purposes." Letter from Arthur Andersen & Co., *supra* note 7, at 4.

113. *See* text accompanying note 70 *supra*.

114. *See* text accompanying note 69 *supra*.

115. Letter from Union Pacific Railroad, *supra* note 95, at 3-4. By changing from betterment accounting to ratable depreciation accounting, Chicago Milwaukee Corp. reduced its loss for third-quarter 1977 by $12.5 million and the loss for the first nine months of 1977 by $16.1 million. Wall St. J., *supra* note 16, at 13, col. 2.

116. Santa Fe Industries estimates its 1977 pre-tax earnings would increase approximately $53 million due to the change in accounting methods, with no increase at all in cash flow. Letter from Santa Fe Industries, *supra* note 8, at 16.

corresponding demands for wage increases[117] and increased resistance to rate increases by regulatory agencies.[118] The failure of higher dividends to accompany the favorable income gains may cause a loss in the credibility of railroads[119] and even induce some investors to sell their shares, depressing railroad stock prices.[120]

These potential transition costs arise only because of lower depreciation charges under ratable depreciation than under the betterment method. By roughly equalizing the depreciation charges under the two methods, the paper profits would disappear.

The primary cause of the earnings discrepancy is the basis of the charges to income, current replacement costs under the betterment method versus lower historic costs under ratable depreciation.[121] By realistically revaluing the historic book value of the track structure to more accurately reflect current value, the resulting depreciation charges would fall more in line with the current charges under betterment accounting.[122] This one-time revaluation would lessen the adverse tax consequences and other transition costs of a switch to depreciation accounting.[123]

Another possible adjustment to bring depreciation expense under ratable depreciation in line with charges under the betterment system is shortening the service lives of the assets.[124] This reduction can be achieved by basing the service life figure on the economic life of the asset, instead of engineering estimates.[125] With track obsolescence due increasingly to economic factors,[126] it is unrealistic to base service life solely on the physical expiration of the asset. With the shortening of the service lives, capital costs will be recovered over a shorter period of time, thus increasing the annual depreciation expense accordingly.

CONCLUSION

The SEC has the opportunity to effectively abolish a hybrid system of accounting whose historical justifications have long since passed. Betterment accounting provides a reasonably accurate gauge of depreciation costs only when the physical quantity of track structure remains fairly constant and the components are replaced on a continuous basis. Financial reports using the betterment method provide a cloudy and distorted picture of a railroad industry marked by record amounts of deferred maintenance and track abandonments. In today's railroad economy, betterment accounting serves as a method of manipulating income statements and inflating balance sheet accounts.

The adoption of ratable depreciation accounting for track structures would be of great benefit to investors. Their decision to invest would be much more in-

117. Letter from the Chessie System, *supra* note 60, at 2; letter from Santa Fe Industries, *supra* note 8, at 16. Labor negotiators will be more likely to push for, and succeed in obtaining, higher wage increases if the company is turning a comfortable profit, paper or not.

118. Letter from Santa Fe Industries, *supra* note 8, at 16.

119. Letter from Financial Analysts Federation, *supra* note 4, at 6.

120. *Id.* at 7.

121. Assuming a track structure with a $100,000 original cost, replacement cost of $200,000, and a service life of 20 years, the depreciation expense under ratable depreciation would be $100,000/20, or $5,000. If the roadbed is properly maintained, the change to income under betterment accounting will be $200,000/20, or $10,000.

122. Comments of the Department of Transportation before the SEC, *supra* note 27, at 23.

123. *Id.*

124. *Id.* at 26.

125. *Id.*

126. *See* text accompanying note 50 *supra*.

formed due to the increased comparability of railroad financial reports. Greater separation of costs under ratable depreciation would also enable financial statement users to independently evaluate the capital replacement program of a particular railroad. Reliability of financial statements would be enhanced since ratable depreciation accounting eliminates the income manipulation possible under the betterment method. Transition costs and implementation problems accompanying such a change should not deter the SEC from imposing ratable depreciation accounting for railroad track structures. When a change in accounting methods results in such a vast improvement in the accuracy of financial reporting, inconvenience during the transition must be discounted.

James Maurice Van Nostrand