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Railroad Annual Reports in the Post World War II Era (1946-1975): A Study in Voluntary Compliance

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Abstract

For much of the twentieth country, the shareholder annual reports of railroads were unique. Through 1975, these reports were exempt from the accounting regulations and disclosure rules of the SEC, because railroads were common carriers subject to the rules and regulations of the Interstate Commerce Commission (ICC).

This study would be classified under accounting history. Its purpose was to systematically analyze the shareholder annual reports of U.S. Class I railroads from 1946 to 1975. The research tool was content analysis which was used to examine the specific formatting, accounting and disclosure practices in a sample of annual reports as the railroads voluntarily moved from an ICC-based accounting and reporting model to one increasingly based on GAAP.

The paper begins with the founding of first American railroads in the late 1820s and reviews their early accounting procedures and financial reporting practices, including voluntary shareholder annual reports. The paper continues through the establishment of the ICC and its efforts to establish a uniform system of accounts for railroads, the early attempts by the investment community to use the industry's standardized financial reports, and reviews early industry practices with respect to internal and external audits.

Overall, the results of the study are both qualitative and quantitative. In aggregate, the results show gradual voluntary change in the formats of the annual reports and in the accounting principles used until around 1960, after which, the rate of change increased. Perhaps the most significant findings related to the voluntary presentation of audited financial statements which were not required railroads until 1976.

Keywords: *railroad accounting, annual reports, accounting history, ICC*

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I am indebted to those who supplied the annual reports used in the study. Lynn Burshtin, at the National Railway Historical Society, welcomed me repeatedly as a visitor to their library, as did Gregg Ames and the staff of the John W. Barriger III National Railroad Library. Greg also wrote to my committee early on about the significance of my proposed study. My sister, Deirdre Feeney Jameson, arranged for access to the annual reports at the James J. Hill Library and also helped to locate certain reference material.

I am very grateful to the support that I received from my family throughout my doctoral studies. My wife, Carol, served as an early editor while my daughter, Colleen, did all of the data entry and helped greatly with the finished manuscript. Other friends and my colleagues at Gartner also provided continued encouragement and some technical assistance. Still, even with the help and assistance of others, I alone am responsible for any errors or omissions.

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Research is diligent organized investigation to discover facts
Actuated by an attitude of mind that
Prompts one to eternally ask the question 'Why?'
-C.E. Smith, VP, New Haven Railroad in an address at the
Association of American Railroads, "Open Meeting", November 1940

Chapter 1

Introduction

For much of the twentieth century, the annual reports to shareholders of railroads were unique. While other publicly owned corporations, including regulated electric and telephone utility companies, were required to follow the accounting regulations and the disclosure rules prescribed by the Securities & Exchange Commission (SEC) in their annual reports to shareholders, railroads were exempt. Railroads were long considered common carriers subject to the rules and regulations of the Interstate Commerce Commission (ICC). Among other things, the ICC specified the accounting used by railroads and required them to file monthly[1], quarterly and annual reports with the commission. An example of this reporting is **Exhibit 1-1** on the next page. While the ICC Annual Reports were extremely detailed and initially served as the basis for the annual reports to shareholders, they are outside the scope of this study, except to the extent that the ICC's accounting rules impacted the reporting to railroads' public shareholders.

[1] The ICC eliminated the requirement for monthly reporting effective Jan. 1, 1962.

Exhibit 1-1

Railroad
Annual Report Form A
(Class I Line-haul and Switching and Terminal Companies)

Budget Bureau No. 60-R098.20
Approval expires 12-31-66

ANNUAL REPORT

OF

THE ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY

AND

AFFILIATED COMPANIES

(FOR LIST OF COMPANIES SEE PAGE 801)

TO THE

INTERSTATE COMMERCE COMMISSION

FOR THE

YEAR ENDED DECEMBER 31, 1963

As will be explained later in this work, the ICC's regulation of the railroads pre-dated the establishment of the SEC by almost 50 years. Congress recognized the extent of the ICC's oversight when it passed the 1933 and 1934 Securities Acts, by specifically exempting railroads and their publicly traded securities from regulation by the SEC. On the other hand, interstate utility holding companies, with subsidiaries in the electric utility and retail distribution of natural gas businesses, were subjected to direct SEC regulation under the Public Utility Holding Company Act of 1935.

The accounting procedures and financial reporting practices used by the railroad industry came to represent a comprehensive basis[2] of accounting other than generally accepted accounting principles (GAAP). Called "railroad accounting" for lack of a better term, it was used internally, in government filings and in shareholder reports. Through the early 1940s, the financial information contained in annual reports to railroad shareholders was virtually identical to that of their ICC annual reports. The inspiration for this study came from this writer's direct observation that form, content, and the accounting in railroads' annual reports to their shareholders began to change just after World War II.

The changes in accounting were generally made on a voluntary basis by the railroads. They were not ordered by the ICC, SEC or any other rule-setting body. There was rapid change in the format of railroad shareholder annual reports which became more corporate like. In 1950, *Forbes* Magazine [p. 30] noted that most railroads had adopted "dressed-up" annual reports to include "graphs, photos and a pretty cover." On the other

[2] The acronym, OCBOA, is currently used in place of the phase "other comprehensive basis of accounting". The use of this term seemed to have originated in *Statement of Auditing Standards No. 62* which was issued in 1989.

hand, the changes in accounting were subtle at first, and made by only a few railroads. However, this later changed as the railroads began to move away from ICC-type accounting and disclosures towards GAAP-type accounting and disclosures. It appears that these changes were made in response to the needs of users, to varying general business and economic conditions, and also to an evolving regulatory environment.

Railroads were established businesses with extensive capital needs, and their annual reports had to adapt to the changing needs of their financial stakeholders. However, there were many users of railroad annual reports besides stockholders, bondholders and the various financial rating agencies. Railroads often provided an actual or specialized version of their annual reports to their employees, or in other cases, the report highlights were included in their monthly employee magazines. The railroad industry made extensive use of their annual reports in marketing and sales efforts to prospective passengers and shipping agents. This practice seems to have been more prevalent among railroads than industrial companies, which may be one reason why their annual reports from the post World War II era are readily available[3], even decades later.

Many of the railroad annual reports included listings of traffic offices as well as sales, service and industrial representatives on the rear (or rear inside) cover. Direct statements were often made in the reports to cajole shareholders to travel and ship via their "owned" line whenever possible. Even though the railroad industry operated in a unified manner throughout North America, there was fierce competition among the carriers for freight and passenger traffic. Yet, as will be explained later, it was a common

[3] Old railroad annual reports appear regularly for sale on EBay, the internet auction site, which in early 2003 established a separate category (#36010) for them.

practice for executives from the various railroads to exchange annual reports from their respective lines.

While the railroad industry consumed[4] substantial amounts of industrial products, its primary economic role was to provide transportation services to the public and the general business community. To a large degree, it was dependant on market demand for its service. Its ability to grow and adapt was limited by a heavily regulated environment, and one that seemed increasingly to favor alternative means of transportation over the years. Business and economic conditions changed dramatically after World War II, and the rate of change increased as well. As the economy experienced ups and down, the railroad industry basically went along for the ride. The heavy fixed nature of their business operations limited the ability of railroad companies to respond quickly to changing business conditions. However, over time, railroads were able to compensate for this by making changes in their business structures, and these changes were generally announced through their annual reports.

Purpose of Study

This purpose of this study is to systematically analyze the annual shareholder reports of the country's **Class I** railroads[5] during the post-World War II period (1946 to 1975) to observe and document the changes that were made. Accounting records and reports the underlying business of a firm. As businesses change and evolve so must accounting if it is to remain relevant and useful. Since 1939, the accounting rules and

[4] In its 1953 annual report, the Pennsylvania Railroad said it was one of the principal buyers and consumers of the nation's industrial products.
[5] These were railroads with annual revenues of $1 million or more in 1946.

principles for most businesses in the United States have been generally set by three private sector organizations[6], and change has been an inevitable part of this process. At the same time, consistency, the use of the same accounting principles over time, has been a basic tenet in accounting. Because of this, changes in accounting principles are not taken lightly by the CPA profession. In fact, the Accounting Principles Board (APB) issued *Opinion No. 20* in October 1970 that specifically dealt with how to apply changes in accounting. While changes in accounting methods were generally made on a voluntary basis, changes in accounting principles were generally prescribed through new accounting pronouncements. As GAAP became much more formalized, beginning in the early 1970s, the authoritative pronouncements generally included an effective date for the new opinion or statement, and often gave transition rules for applying the required change. However, early adoption was generally permitted and sometimes even encouraged.

The railroads could have continued[7] to use "railroad accounting" in their public annual reports, or they could have changed to GAAP. The type of accounting change that is the subject of this study is one change in the underlying basis of accounting, and one that was made on a voluntary basis. This was fundamentally different from the accounting changes described in the preceding paragraph. The notion here is that the change was made as the result of making a choice. Change here, by itself, denotes solely a switch from one basis of accounting to another. It says nothing about whether the change was for the better, or for the worse. However, since the changes of interest to this

[6] The Committee on Accounting Procedure (1939-1959), the Accounting Principles Board (1959-1973) and the Financial Accounting Standards Board (1973-Present).
[7] Up through 1975.

study were made on a voluntary basis, one would have to assume that they represented improvements in accounting and reporting, or perhaps were more advantageous in some way to the railroad, its management, or both. It is hard to think of a situation where a rational company would voluntarily make a change in accounting that made it worse off. Thus this also implies that by changing to GAAP, the railroads were adopting a "better" system of accounting, one that produced financial statements that were more useful in assessing the economic condition of the firm. Such a view of accounting supports the decision-usefulness theory of accounting [Staubus, 1999].

However, better alone is not a sufficient reason for making the change. There were real costs to the railroad of making the change which included the effort required to restate the prior years' results in accordance with GAAP, as well as the cost of training accounting personnel in the new accounting procedures and policies. If a railroad chose to have audited financials, which were **not** required, that would have entailed additional costs. In a rational decision-making process, the marginal benefits of making the change needed to exceed the marginal cost of doing so, and usually not by an immaterial amount. In cost-benefit analysis, it is usually much easier to quantify the costs, which tend to be fairly certain, than to quantify the benefits which generally are far more subjective and conditional. In formalized cost-benefit analysis, it is often required that the benefits exceed the costs by a considerable margin, such as a ratio of 2:1 or more.

It is unlikely that such structured decision-making was applied in this case. The railroad industry during the period of inquiry was beset with a host of economic and financial problems that seemingly had nothing to do with accounting. Of interest to this study is whether these environmental factors affected the railroads' decision to change

their accounting. Railroads were an asset-intensive business with substantial amounts of publicly-held debt, yet there was considerable variation in their firm size and capital structures. Of interest to this study is whether the differences in these characteristics affected the railroad's decision to change its accounting. One can postulate that the presence of certain environmental factors or firm characteristics may help to predict whether, or how quickly, the change in accounting was made. Alternatively, the decision to change accounting may have been a total surprise from what would have otherwise been expected. The extent to which GAAP-type accounting and disclosures appeared, before they were ultimately required, was an indication of the importance that the railroads, their shareholders and perhaps the market placed on them.

This study would be classified under the heading of accounting history. Unlike traditional methods of accounting research, the analysis of the data in accounting history research occurs simultaneously with the data collection. The data in accounting history research is generally found within actual accounting documents, such as the annual reports used in this study. The accounting historian collects the documents (the annual reports in this case), analyzes them, and asks questions of them until a complete picture of an event or chain of events ultimately emerges. The accounting historian records his/her observations and formulates them into a narrative of history. The changes in accounting and reporting that were observed in this study were the result of a complex interaction of situations, circumstances and other considerations, many of which cannot be quantified, and hence do not lend themselves to analysis by conventional empirical means.

In 1970, a committee of the American Accounting Association encouraged research in accounting history, saying that such research could be biographical, institutional, technical, empirical, or a combination thereof. The committee stated [p. 53] that accounting history should serve both intellectual and utilitarian purposes. It serves an intellectual purpose by illuminating the developmental processes of thought, practices and institutions, by identifying those environmental factors that induce change, and by revealing how and when change actually occurs. Accounting history serves a utilitarian purpose by identifying the origins of concepts, practices, and institutions which provides an insight for the solution of modern problems. This committee further said [p. 55] that the relevance of accounting history to accounting is no less important than medical history to medicine, legal history to law, economic history to economics, or architectural history to architecture. An understanding of how past accounting practices and institutions interacted within the context of the economic environment may be helpful in predicting the consequences of proposed new accounting procedures.

The way in which the accounting history approach is applied in this study is described in detail in Chapter 6. The research questions are identified in this chapter and expanded upon in that chapter. The research questions were not stated as formal hypotheses, as it was expected that the answers to the questions would flow from the analysis of the respective annual reports. The identified research questions were grounded in observations of this writer, as well as statements and conjectures made by others, and are the following:

1) **Does reporting of a particular type of information become more detailed and elaborate with the passage of time?** There are several ideas implicit in this

question. *First*, reporting is viewed as an evolutionary process that builds on itself. *Second*, as some information is provided, more will generally be desired by the users of the annual reports. Finally, the company must balance the benefits of providing more information vs. the cost of providing it. If the answer to this question is found to be true, then it can be inferred that the benefit of providing the information exceeded the cost of doing so.

2) **To what extent were the voluntary changes in railroad reporting practices a shared experience?** The railroad industry was long established; to a large degree it operated on a unified basis that was closed to outsiders. Within the industry, it operated under many standardized practices: standard gauge, standard time, standard safety and operating procedures. Actions well-taken by one railroad were soon known by other railroads, and this would have applied to the changes made in their annual reports.

3) **Were voluntary changes made in accounting and reporting at the same time by the whole industry, or were they made first by one railroad and then followed by the others?** This follows the previous question. The "all at the same time phenomena" has been observed with accounting changes made in other industries. While it may be difficult to explain the motivation of the railroad that changed first, it is easier to understand why others changed once a critical mass has been reached. The study hopes to identify when critical mass was reached and whether external events were a contributing factor.

4) **How did the railroads' accounting and reporting practices respond to certain external events that occurred during the period of inquiry?** Specific examples of this include the Internal Revenue Code of 1954, the Penn Central

Bankruptcy of 1970 and discontinuance of passenger service in 1971. A more generalized example is how railroad accounting responded to changes made to GAAP itself during the same period.

5) **Are there any organizational factors such as size, profitability, leverage, etc. that help to explain why the amount of information disclosed in the annual reports generally decreased during the period of inquiry**? Some railroads stopped including many or all of the ICC style schedules in their annual reports during this period. It would be helpful to be able to generalize upon what type, size, etc. of railroads were most likely to do this.

6) **Are there any organizational factors such as size, profitability, leverage, etc. that help to explain why some railroads made extensive use of graphic elements in their annual reports while others did not use any graphical elements?** It was observed that some railroad annual reports made great use of graphic elements while others used none. It would be helpful to be able to generalize about what type of railroads, in terms of size, profitability, etc. was most likely to use graphic elements in their annual reports. In another study, a linkage between graphic usage and profitability was found, and it would be interesting to see if the same linkage also held here.

7) **How did the form of the financial statements change during the period of inquiry, and are there any organizational factors that help explain these changes?** Elements of form include order of the statements, the unit of money, the degree of comparability, as well as the particular formats of the balance sheets and income statements. It would be helpful to be able to generalize upon what type of railroads in terms of size, profitability, leverage, etc. were most likely to employ certain forms.

8) **How did the basis of presentation change during the period of inquiry, and are there any organizational factors that help explain these changes?** The basis refers to the underlying accounting employed. In 1946, it was exclusively ICC accounting, but over time the basis became a hybrid as more and more elements of GAAP were introduced. Some railroads even gave a unique "dual" presentation of net income and earnings-per-share under both bases of accounting. By 1970, GAAP presentations were in the majority and ultimately all railroads reported under GAAP in their shareholder reports. It would be helpful to be able to generalize upon what railroads in terms of size, profitability, leverage, etc. were most likely to use GAAP. It should be noted that, during the 1950s, the public accounting profession took action to minimize the differences between GAAP and railroad accounting.

9) **To what extent did the railroads make use of the standardized reporting that existed in the industry in terms of benchmarking or other comparative analysis?** The railroad industry long employed many standardized practices. The ICC and Association of American Railroads (AAR) prepared various summary reports that presented comparative performance using standardized accounting data filed by the railroads. These reports were in the public domain. One measure widely compared was the operating ratio.

10) **Did the unique nature of railroad operations justify the methods of depreciation that were long used in the industry?** The railroads were capital intensive businesses that employed large amounts of long-lived assets. The nature of their business was that these assets needed to be constantly maintained, and in doing so, the industry argued that no depreciation was necessary. The battle over whether to depreciate or not