1980

Accounting for intangibles in the motor carrier industry; Issues paper (1980 August 13)

American Institute of Certified Public Accountants. Motor Carrier Special Committee

August 13, 1980

ISSUES PAPER

ACCOUNTING FOR INTANGIBLES IN THE MOTOR CARRIER INDUSTRY

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INTRODUCTION

1. Enactment of the Motor Carrier Act of 1980 (the Act), which became law on July 1, 1980, has raised concerns as to the recoverability of present carrying amounts of operating rights in the financial statements of many motor carriers. The Act is expected to change the character of operating rights. As a result of the Act, the market price of operating rights is expected to decrease substantially, the exclusiveness of those rights is considerably lessened because restrictions on entry into a particular market is significantly reduced thus increasing significantly the potential competition in a particular market. Therefore, guidance is needed on accounting and financial disclosures required to reflect the effects on motor carriers of the deregulation inherent in the Act.

Definitions of Terms

2. The following are definitions of some of the terms used in this paper:

<u>Common carrier</u> - A person who transports goods for hire for the general public and assumes the responsibility for safe and proper handling of goods while in his care.

<u>Operating right</u> - (operating authority) - A franchise or permit to transport freight over specified routes, either granted directly by the Interstate Commerce Commission (Commission) or purchased from another motor carrier.

Traffic lane - Route or lane of traffic between two points within the carrier's area of operations.

Background

3. Intangible assets are significant to many motor carriers and to the industry as a whole. Most of those intangibles are described in the financial statements of motor carriers as "operating rights" or "operating authorities." The carrying amounts of intangibles in the financial statements of motor carriers range from zero to nearly 100% or more of shareholders' equity; the amount of recorded intangibles is about 15% of shareholders' equity for the industry as contrasted with about 5% for industry as a whole.

4. Mergers and acquisitions have been common in the industry. That activity increased significantly in the late 1960s and led to the growth of many of the companies that are the leaders in the industry today, many of which were small 30 or even 20 years ago.

5. Commission regulations before July 1, 1980 required common carriers to obtain operating rights to handle specific types of freight over specific routes or within specific territories. Before 1960, the Commission granted rights to carriers that applied for them and could demonstrate that they could serve the customers in those routes or territories. Ownership of the rights was accompanied by the obligation to serve all customers who needed the service.

6. As the number of carriers serving various routes or territories increased, the Commission gradually began to limit the number of rights granted, and, by the 1960s, the Commission granted few new rights except for a segment of traffic that was not being adequately served. To expand their operations, carriers had either to increase their share of the market within the territories in which they operated or acquire operating rights for other routes by acquiring other carriers or purchasing operating rights from other carriers.

7. Although many of the carriers acquired were in significant financial or operating difficulty, relatively significant prices were often paid to obtain those companies or their operating rights. The only significant asset acquired was usually considered to be the operating rights, and substantially all of the cost over the current value of the tangible property was assigned as the cost of the operating rights. Some amounts were identified as goodwill or other types of intangibles. Many operating rights were also purchased separately, providing further evidence of the value of the operating rights.

8. Key provisions of the Act provide for

- easier entry into the trucking industry for new carriers and easier route expansion for existing carriers.
- removal of most route restrictions and a broadening of the classifications of commodities carriers are permitted to haul.

- eventual freedom for trucking firms to change freight rates without the Commission's permission.
- limitations on the scope of collective ratemaking exempt from antitrust considerations.

Many of those provisions affect the recoverability of the carrying amounts of operating rights.

History of Accounting for the Cost of Operating Rights

9. The cost of operating rights originally represented primarily legal fees and out of pocket costs incurred to obtain the rights from the Commission. Those costs have continued to be incurred in obtaining operating rights from the Commission. Most costs to obtain operating rights, however, are now incurred to buy them from other carriers.

10. The Commission's prescribed rules for accounting for the cost of operating rights have changed over the years. Before 1961, the Commission required immediate write off of those costs or their amortization over periods generally not exceeding five years as a condition of approval of such an acquisition, even though the Uniform System of Accounts prescribed by the Commission did not require their immediate write off or amortization.

11. In 1961, the Commission revised its policy and issued an order stating that henceforth no condition would be imposed in a purchase, merger, or consolidation transaction requiring amortization or write off of the amount recorded in Account

1550, Other Intangible Property, of the Uniform System of Accounts. Under this policy, the Commission usually has not required amortization or immediate write off. The Commission issued Instruction 29 to its Uniform System of Accounts, which states that, "When it becomes reasonably evident that the term of existence . . . has become limited or its value impaired, its cost shall be amortized or entirely written off . . . ." The Commission further stated its position in Case 208 of its Motor Carrier Accounting Interpretations, which provides that, "When operating rights are acquired through purchase, merger, or consolidation . . . any excess of the amount actually paid by the acquiring carrier over the cost to the original holder, together with the expenses incident to transfer of the rights, shall be charged to Account 1550, Other Intangible Property . . . when it becomes reasonably evident that the term of existence of an intangible . . . has become limited or its value impaired, amortization or write off shall be effective in conformity with the provision of Instruction 29."

12. The effects of those provisions were that the Commission permitted carriers to use their own discretion in amortizing operating rights, except that amortization was required if the term of existence became limited or the company became unable to recover the carrying amount of those rights. Therefore, beginning in 1961, the Commission's prescribed accounting procedures for intangibles conformed with generally accepted accounting principles. Chapter 5 of Accounting Research Bulletin No. 43,

issued in June, 1953, prescribes generally accepted accounting principles for intangibles acquired before October 31, 1970. That bulletin provided that:

- intangible assets should be recorded at cost.
- intangibles with fixed or determinable lives should be amortized by systematic charges in the income statement over the periods benefited, with adjustments to the amortization for changes in estimated lives.
- the carrying amount of intangibles without fixed or determinable lives may be amortized but are not required to be amortized or written off until it becomes reasonably evident that their term of existence has become limited or the asset has become worthless.
- lump sum write off of intangibles should not be made to earned surplus immediately after acquisition.
- the carrying amounts of intangibles should not be charged against capital surplus.

13. After 1961, few carriers amortized the carrying amounts of operating rights, because their full recoverability had not been lost.

14. A significant difference developed between generally accepted accounting principles and accounting prescribed by the Commission by adoption of Accounting Principles Board Opinion No. 17, Intangible Assets (APB No. 17), effective for intangible

assets acquired subsequent to October 31, 1970. APB No. 17 requires the cost of intangible assets to be amortized by systematic charges to income over the period estimated to be benefited, not to exceed forty years.

15. After APB No. 17 was issued, the Commission became concerned about the applicability to the cost of motor carrier operating rights of the provisions of that Opinion requiring amortization of intangible assets. Accordingly, on February 9, 1972, the Commission issued a request for comment on the propriety of applying APB No. 17 to motor carrier operating rights. As part of that request, the Commission stated that, "Effective immediately and for the duration of our review of the subject matter, Accounting Interpretation Case 208 in Accounting Circular No. MF-3 is hereby suspended. The effect of this suspension will preclude the amortization or write off of any intangible assets until it is reasonably evident that the term of existence of the asset has become limited or its value impaired." Therefore, carriers must now amortize the cost of operating rights acquired after October 31, 1970, to conform with generally accepted accounting principles but are now prohibited by the Commission from recording any such amortization unless conditions specified in the Commission cases and interpretations exist. However, the Commission recently has approved for issuance Accounting Series Circular No. 182, which would conform Commission policies to generally accepted accounting principles.

16. Most carriers do not distinguish purchased operating rights from other purchased intangibles in their financial statements and in their underlying Accounting records. In financial statement prepared in conformity with generally accepted accounting principles, the cost of operating rights acquired after October 31, 1970, have been amortized and the cost of intangibles reported before 1961 have been written off. The amortization of operating right has generally been treated as a permanent book and income tax difference, since the amortization has not generally been allowed as a deduction for tax purposes.

BASIC ISSUE

17. The basic issue is:

> How should motor carriers that have operating rights recognize and report the effects of the Act on those rights?

Suggested approaches include:

a. Direct write off.

b. Realizable value concept.

c. Amortization over a three year period.

Direct Write Off

18. Under the direct write off method, the carrying amounts of operating rights would be immediately written off as a result of the signing of the Act. Those who hold this view believe that the operating rights have lost their value because the Act lessened restrictions on entry and the operating rights no longer assure a quasi-monopolistic situation. A problem

with the write off method is to determine at what point the full effect of deregulation occurs.

Realizable Value Concept

19. Carriers now established in markets will, for the most part, continue to be the dominant carriers in those markets and continue to operate over the routes represented by the operating rights that were acquired earlier, even if restrictions on entry into various markets have been significantly lessened or if entry has become completely free. Proponents of the realizable value concept argue that as long as the carrier can continue to operate profitably on those routes, those rights continue to be valuable. They believe that if the operations are still being maintained over the routes covered by the operating rights and if they are still profitable, a return is still being realized on the investment in operating right. Conversely, the cost of routes that can no longer be operated profitably or that have been abandoned should be written off.

20. The need to assign the total cost of intangibles to the individual segments of operating rights makes implementation of the realizable value concept difficult. The assignment would be arbitrary for most acquisitions. Further, a substantial consideration in most acquisitions is the ability to add the new right to an existing right and therefore, presumably, part of the cost should be assigned to the existing operating right.

21. A similar problem is the difficulty of determining whether a segment of the operating right is operating at a profit level sufficient to substantiate the "realizable value." While it is easy to determine whether the carrier is currently maintaining operations over a route covered by a given piece of right, it may not be as easy to determine the profitability of the operations over that route. Thus, it may be impossible to determine whether a return is still being realized on the original route.

22. While many carriers maintain current operating statistics as to the volume of freight hauled over individual traffic lanes, many can not analyze relative profitability on that basis. Thus, a carrier's overall operations and profitability would need to be assessed to determine the relative value of its operating rights.

<u>Amortization Over a Three Year Period</u>

23. Some believe that, to minimize the effect of the Act on the reported results of carriers, the recognition of the effects of the Act should be phased in over a period of time, for example, amortization of existing operating rights over a three year period. That proposal is considered by its proponents to be in keeping with the thinking behind the present requirements for amortizing intangibles over not more than 40 years and with other examples such as the phase in of the requirements for capitalization of leases, loan agreement amendments, and implementa-

tion of administrative requirements necessary in the transition of new rules.

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ADVISORY CONCLUSION

24. Based on the enactment of the Motor Carriers Act of 1980 (the Act), and recent actions and decisions by the Commission, the AICPA Motor Carrier Special Committee and the AICPA Subcommittee on ICC Regulated Carriers believe that the carrying amounts of operating rights should be written off as an extraordinary item in 1980.

25. However, AcSEC believes that the carrying amount of operating rights should be written off as an extraordinary item in 1980 if the inability to fully recover the carrying amounts is probable. The AcSEC view recognizes that the Act changes the economic effects of owning operating rights since (1) the resale value of the rights, which has often justified past carrying amounts, is no longer an important consideration and (2) the rights no longer convey the same competitive advantages as in the past. Consequently, the Act creates a presumption that there is an inability to recover fully an investment in operating rights and that the carrying amounts of such rights should be written off. However, AcSEC believes that there may be circumstances that would justify not making such a write off.

26. Tax benefits received as a result of the Act should be accounted for in accordance with FASB Interpretation No. 22, "Applicability of Indefinite Reversal Criteria to Timing Differences."

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