

EX PARTE No. 460

**CERTIFICATION OF RAILROAD ANNUAL REPORT R-1  
BY INDEPENDENT ACCOUNTANT  
(49 CFR PART 1241)**

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*Decided September 26, 1985*

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**AGENCY:** Interstate Commerce Commission.

**ACTION:** Final rule.

**SUMMARY:** The Commission is adopting a reporting revision that will require Class I railroads to submit a report from an independent public accountant stating that specified data in the R-1 annual report have been examined, using agreed-upon procedures, and found in compliance with the Uniform System of Accounts for railroad companies. The report would also present any material exceptions which came to the attention of the accountant during the examination. This revision will provide an alternative to the audits currently being performed by the Commission Staff.

This revision has been submitted to the Office of Management and Budget (OMB) for review under section 3504(h) of the Paperwork Reduction Act of 1980 (44 U.S.C. Chapter 35). Respondents may direct comments to OMB by addressing them to the Office of Management and Budget, Office of Information and Regulatory Affairs, Attention: Desk Officer for Interstate Commerce Commission, Washington, DC 20503.

**DATE:** Effective for the R-1 annual reports filed for the year 1986 which are to be filed by March 31, 1987.

**FOR FURTHER INFORMATION CONTACT:**

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**SUPPLEMENTAL INFORMATION:**

In this proceeding, the Commission has proposed to have the railroads' independent public accountants certify certain schedules in annual report Form R-1 which is filed with the Commission. 50 F.R. 18539 (1985). At the request of the American Association of Railroads, two requests for extension of time to file comments were granted. Also, at the request of the AAR, the Commission clarified the extent of the independent accountant's attestation. 50 F.R. 25282 (1985).

Comments were filed by the Association of American Railroads (AAR), Norfolk Southern Corporation (NS), Elgin, Joliet and Eastern Railway Company (EJE), American Institute of Certified Public Accountants (AICPA), Deloitte Haskins & Sells (DHS), Ernst & Whinney (EW), Peat, Marwick, Mitchell & Company (PM), John A. Murray (Murray), Margaret L. Carey (Carey) and Patrick W. Simmons (Simmons).

The AAR, NS and EJE stated that the certification proposed in the NPR would be expensive and a heavy burden on the railroad industry. The AICPA, EW and PM concurred, adding that the proposed certification would substantially increase the scope of audits performed by independent public accountants and substantially increase their audit fees.

The AAR and EW also argued that the proposal is inappropriate at this time, and that the Commission should delay any change in its audit program until the Railroad Accounting Principles Board (RAPB) has considered the issues of data integrity and audit standards.

The EJE stated that the current centralization of the R-1 audit function within the Commission is a contributing factor to uniform interpretation of Commission rules and transferring the audit responsibility to independent accountants could result in differing interpretations and increase the likelihood of inconsistency in reporting.

Simmons and Carey questioned the credibility of annual report form R-1 data if it is not audited by the Commission's audit staff.

The EJE and Murray are of the opinion that the review of the independent public accountant's workpapers by the Commission audit staff would result in work duplication. However, the AAR stated that this review procedure should be required to assure that the current reliability of R-1 data continues.

The AICPA, EW, and PM stated that the proposed auditors' report does not conform with professional reporting standards in AICPA Statement on Auditing Standards No. 35. Under these professional reporting standards, auditors cannot issue a report that provides positive assurance on operating statistics (Schedule 755).

The AAR, AICPA, and DHS stated that the ICC audit staff, which currently audits the Form R-1 data, does not provide any positive assurance reports as proposed in the NPR.<sup>1</sup>

The AAR urges the Commission to retain the audit function for Schedules 410 and 755, and believes the independent public accountants' present audit reports to stockholders should provide the Commission with adequate audit coverage on the basic financial statements. However, if the Commission is unable to do so, the AICPA and the AAR offer a constructive alternative.

#### ALTERNATIVE PROPOSALS

The AICPA and the AAR propose that:

(1) The independent public accountant issue a negative assurance report based on agreed-upon procedures for critical regulatory data contained in the selected R-1 schedules.<sup>2</sup>

<sup>1</sup>The term "positive assurance," as used in this proceeding, means an auditor's report developed in accordance with the reporting standards mandated by generally accepted auditing standards. Such a report would state the scope of the auditing procedures performed and contain an unqualified, qualified or disclaimer of opinion that the financial statements are in accordance with generally accepted accounting principles (GAAP) and applied on a consistent basis. (Statement on Auditing Standards No. 1).

<sup>2</sup>The term "negative assurance," as used in this proceeding, means a specialized auditor's report developed in accordance with the reporting requirements described in Statement on Auditing Standards (SAS) Nos. 14 and 35. Negative assurance implies that the financial information may be in accordance with GAAP, since nothing of a material nature to the contrary was discovered during the performance of the auditing procedures. SAS No. 14 specifies that a negative assurance report can only be expressed when an auditor is engaged to report on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements.

(2) The agreed-upon procedures should be developed by a joint task force composed of representatives of the AICPA, the Commission, and the AAR.

(3) The independent public accountant would issue a report as provided for in the AICPA Statement on Auditing Standards No. 35.

(4) The Commission staff would review the independent public accountant's workpapers to ensure that the tests performed to verify the compilation of the data are in accord with the agreed-upon procedures. Any deficiencies or errors set out in the independent public accountant's report would be resolved as considered necessary by the Commission audit staff.

In a supplemental response, the NS endorsed this alternative and stated that the proposal would enable the Commission to discontinue its present continuous audits, maintain or even enhance the integrity of reported data critical to the regulatory process, and minimize burden and cost to the railroad industry.

The EW, DHS, and PM responses include suggestions similar to the alternative proposal. They emphasize the limiting of the data elements to those which are critical and significant to the regulatory process. The AICPA stated that the alternative proposal would result in no major increase in the scope of testing or reporting relative to the scope of work currently performed by the Commission's staff auditors. The AICPA also suggests that the Commission define insignificant exceptions that do not have to be reported.

PM requested that the Commission clarify the "cyclical" audit referred to in the NPR.<sup>3</sup>

#### DISCUSSION

As we stated in the Notice of Extension of Time to File Comments, published in the Federal Register on June 17, 1985 (50 F.R. 25282), the finalization of the standards to be developed by the RAPB and their subsequent implementation would extend further the amount of time the instant proceeding and its implementation would be delayed. Therefore, the Commission will consider any necessary changes at such time as those standards are issued by the RAPB.

Our proposal was a starting point, and the intent was to attain the same reliance in the data reported by the railroads as we currently attain with the audits performed by Commission audit staff.

In the NPR, we recognized that an expanded audit scope by the independent public accountants would undoubtedly result in incremental audit fees. The extent of the increase in audit fees would be greatly alleviated under the alternative proposals.

We do not believe that transferring the audit responsibility will result in any significant difference in interpretations of the Commission's accounting rules. The Section of Accounting and Reporting in the Bureau of Accounts prepares interpretations in the form of Accounting Series Circulars for the industry and letters to individual carriers. This will not change under the instant proceeding. In addition, the Commission's auditors will review the independent public accountants' workpapers for inconsistencies within the industry. As noted

<sup>3</sup>Rather than delay further this proceeding, we will consider any necessary changes at such times as new standards are issued by the RAPB.

earlier, the AAR agrees that our review of the workpapers is required to assure the continued reliability of the data.

The credibility of the railroad reported data should remain unchanged under the alternative proposals submitted by the AAR and the AICPA. The independent public accountants will be performing the same type of procedures and tests on the data to be reported upon as currently being performed by Commission auditors. Again, the review of the independent public accountants' workpapers by the Commission's auditors will assure that the proper procedures and tests are being followed.

We also note that many Government agencies, including the Federal Energy Regulatory Commission which was referred to in the NPR, rely on the reports of independent public accountants for verification of data.<sup>4</sup>

#### ALTERNATIVE PROPOSAL

We have studied the AICPA and AAR's alternative proposal and the similar suggestions by EW, PM and DHS. We believe they have merit and can be adopted to meet the Commission's objective.

Our objective is that the data filed by the railroads with the Commission conform in all material respects with the accounting requirements of the Commission, as set forth in its Uniform System of Accounts for Railroad Companies, and orders issued by the Commission.

At the present time, our auditors examine the railroad's records for inaccuracies and improper accounting or reporting. When errors are found, a report is issued to the railroad requesting correction. If no material errors are found, a report is issued stating that fact. In essence, our auditors issue a negative assurance report as proposed by the AAR and AICPA. Since the Commission will be receiving the same level of assurance under the alternative proposals as it receives from our current audit program, we believe this alternative is acceptable.

The AAR states that, in recent years, the differences between generally accepted accounting principles and the Uniform System of Accounts have been substantially reduced with a corresponding reduction in the differences between the resulting statements. Since the regulatory need of the basic financial statements (Schedules 200, 210, 240 and 245) is limited, the AAR proposes that the Commission accept the independent public accountant's present audit reports and not require a separate audit of these schedules.

We agree with the AAR that the independent public accountants' present report on the basic financial statements, as a whole, are acceptable for our regulatory needs. However, specific data elements within the basic financial statements are used in our ratemaking process, and we do need assurance of their credibility. Those data elements would have to be included in the agreed-upon audit procedures.

<sup>4</sup>Securities and Exchange Commission, Department of Housing and Urban Development, Department of Health and Human Services, Environmental Protection Agency, and Department of Education.

We have again reviewed the data elements needed to fulfill our regulatory responsibilities under the Interstate Commerce Act, the 4-R Act of 1976, and the Staggers Rail Act of 1980.<sup>5</sup> As stated in our Notice published July 22, 1985, the data in the listed schedules is generally used as a whole and cannot be separated into audited and nonaudited segments. However, some data elements are more critical to our regulatory functions. Accordingly, we have limited the data elements to those which we consider essential to meet our responsibility. Using this criteria, Schedules 200, 210, 240, 310, 310A, 450, and 512 will be eliminated in their entirety. Noncritical elements in the remaining schedules will also be eliminated. Several data elements in Schedule 415, Supporting Schedule—Equipment and Schedule 700, Mileage Operated at Close of Year, have been added due to elimination of data elements in other schedules.

The alternative proposal to have the independent public accountants' report based on procedures developed by a joint task force composed of representatives of the AICPA, AAR and Commission is endorsed by DHS, EW, and PM.

We agree that specific procedures would have to be developed so that our auditors can review the work performed by the independent public accountants to verify the compilation of the data reported in the R-1.

However, we believe that participation by the AAR in developing the audit procedures to audit its member railroads would present a conflict of interest. Generally Accepted Auditing Standard No. 2 states that an auditor must be independent. We interpret this to include the development of audit procedures to be used in auditing a client's records. Consequently, representatives of the AICPA and the Commission will develop the audit procedures. This will preclude any implication of conflict or self interest on part of the railroads.

The proposal that the independent public accountant issue a report as provided for in the AICPA Statement on Auditing Standards (SAS) No. 35 is also endorsed by DHS, EW, and PM.

Since the independent public accountants will be performing specific procedures on specific data elements, rather than the financial statements as a whole, a report issued in accordance with SAS No. 35 would be appropriate. As noted earlier, this report would substantially be the same as currently issued by Commission auditors. We will not specify the report language, but the independent accountant will be required to report, in accordance with SAS No. 35, any adjustments which come to their attention as a result of applying agreed-upon procedures to the specified data elements.

The Commission has been using a general materiality factor of 10-percent in taking exceptions to accounting and reporting errors. The 10-percent materiality factor would be continued and would apply to the specific data element or group of data elements being audited.

The cyclical audit referred to in the NPR is a current practice of our auditors in which a major segment of accounting and reporting, such as revenue accounting, expense accounting, property accounting, or statistics is audited each year. Over a 3-year cycle, all major segments are audited. This practice

<sup>5</sup>The Interstate Commerce Act and related laws enacted as subtitle IV of Title 49, United States Code, "Transportation," by Public Law 95-473.

spreads the cost of an audit over three periods, and was suggested in the NPR to alleviate the cost of the Commission's proposal. We do not believe this practice would be appropriate under the alternative proposal because of its reduced audit scope.

Since new audit procedures have to be developed for several hundred items, we do not believe that the new audit program can be completed in time for the 1985 annual reports. Accordingly, we will implement the new program for the 1986 annual reports due March 31, 1987.

#### CONCLUSIONS

We believe the AICPA and AAR alternative proposal will meet our objective to sustain our current level of confidence in data reported by the railroads.

The Bureau of Accounts is directed to meet with representatives of the AICPA to develop audit procedures necessary to assure the continued reliability of reported data.

The audit procedures developed will be used in auditing the data filed in the R-1 report for 1986.

The auditors' report will be prepared in compliance with SAS No. 35 and the railroads will file the report as an integral part of the annual report R-1.

The auditors' report will cover the data elements listed in the appendix.

#### REGULATORY FLEXIBILITY ACT:

This proposed rule will not have a significant economic impact on a substantial number of small entities. This decision directly affects only Class I railroads which have annual revenues of \$50 million or more.

This decision will not significantly affect the quality of the human environment or the conservation of energy resources.

List of subjects in 49 CFR Part 1241:

Railroads; Reporting and recordkeeping requirements.

These rules are proposed under the authority of 11145 and 5 U.S.C. 553.

COMMISSIONER LAMBOLEY, commenting:

I would have preferred to defer action on the proposed final rule pending completion of the Railroad Accounting Principles Board's re-evaluation of existing accounting requirements. In my view, the proposed action is premature at this time.

COMMISSIONER SIMMONS, dissenting:

I would have granted the AAR petition of June 4, 1985 to hold this proceeding in abeyance until the Railroad Accounting Principles Board develops standards regarding the audit of financial data submitted by the railroad industry as required by Congress.

By the Commission, Chairman Taylor, Vice Chairman Gradison, Commissioners Sterrett, Andre, Simmons, Lamboley, and Strenio. Commissioner Lamboley commented with a separate expression. Commissioner Simmons dissented with a separate expression.

## APPENDIX

*Data elements in Annual Report Form R-1 which are to be examined by an independent public accountant and reported upon in accordance with the provision of Ex Parte No. 460*

The references for the data elements listed below are to Form R-1 for 1985. From time to time, the R-1 is revised with resulting changes in the line and column identifications. The railroads will be advised of all such changes.

*Schedule*

- 200 *Comparative Statement of Financial Position*
  - Line 30, column (b)
  - Line 39, column (b)
  - Line 41, column (b)
  - Line 42, column (b)
  - Line 43, column (b)
  - Line 44, column (b)
  - Line 45, column (b)
  - Line 46, column (b)
- 210 *Results of Operations*
  - Line 7, column (b)
  - Line 17, column (b)
  - Line 22, column (b)
  - Line 38, column (b)
  - Line 39, column (b)
  - Line 40, column (b)
  - Line 41, column (b)
  - Line 44, column (b)
  - Line 67, column (b)
- 245 *Working Capital Information*
  - Line 28, column (b)
- 330 *Road and Equipment Property*
  - Lines 1 through 44, column (h)
- 330A *Improvements on Leased Property*
  - Lines 1 through 44, column (h)
- 335 *Accumulated Depreciation—Road and Equipment Owned and Used*
  - Lines 1 through 41, column (g)
- 342 *Accumulated Depreciation—Improvements to Road and Equipment Leased From Others*
  - Lines 1 through 39, column (g)
- 352A *Investment in Railway Property Used in Transportation Service (By Company)*
  - Line 31, columns (d) & (e)
- 352B *Investment in Railway Property Used in Transportation Service (By Property Accounts)*
  - Line 44, columns (b),(c),(d),(e)
- 410 *Railway Operating Expenses*
  - Lines 1 through 620, column (h)
  - Crosschecks to Schedules 412, 414 & 417
- 415 *Supporting Schedule—Equipment*
  - Line 43, columns (b) & (f)

*Schedule*

- 510    *Debt Holdings*  
      Summary included in Instruction 8
- 700    *Mileage Operated at Close of Year*  
      Line 57, columns (d) through (j)
- 755    *Railroad Operating Statistics*  
      Lines 1 through 89, column (b)  
      Lines 98 through 129, column (b)

1 I.C.C. 2d