Instructional Case: Ryder System, Inc. -- Reporting The Results Of Operations

By: **Kennard S. Brackney** and William A. Collins

Abstract

Ryder System, Inc.: Reporting the Results of Operations is based on the experience of an actual company during the mid to late 1980s and early 1990s. During this period, Ryder System, Inc., as well as many other companies, experienced a series of distinct phases: rapid expansion, then slowing growth, then recession-induced restructuring and refocusing of operations. Ryder's strategic and operating actions during these phases, the perception of these actions expressed in the financial press, and the results of these actions reported in the statements of earnings and related notes provide the basis for the case. The case frames Ryder's reporting of operations within the context of the company's business decisions and within the context of the information provided to the market by other sources. These framings are designed to provide students with a richer appreciation of the environment in which a business operates, the business decisions made in response to changes in that environment, the operating results of implementing those decisions, and the description of those results provided by the financial press and by financial statements. Within Ryder's financial statements, many significant accounting issues are reported. These include ordinary income, unusual items, discontinued operations, extraordinary items, changes in accounting principles and revisions of estimates. Students experience the reporting of these items as well as certain strategic aspects of reporting, such as incentives to manage earnings.

Brackney KS, Collins WA. Instructional Case: Ryder System, Inc.: Reporting the Results of Operations. Issues in Accounting Education. 1995;10(2):351-375. Publisher version of record available at: https://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=9601071256&site=eds-live&scope=site

Issues in Accounting Education
Vol. 10, No. 2
Fall 1995

Instructional Case: Ryder System, Inc.: Reporting the Results of Operations

Kennard S. Brackney and William A. Collins

ABSTRACT: Ryder System, Inc.: Reporting the Results of Operations is based on the experience of an actual company during the mid to late 1980s and early 1990s. During this period, Ryder System, Inc., as well as many other companies, experienced a series of distinct phases: rapid expansion, then slowing growth, then recession-induced restructuring and refocusing of operations. Ryder's strategic and operating actions during these phases, the perception of these actions expressed in the financial press, and the results of these actions reported in the statements of earnings and related notes provide the basis for the case.

The case frames Ryder's reporting of operations within the context of the company's business decisions and within the context of the information provided to the market by other sources. These framings are designed to provide students with a richer appreciation of the environment in which a business operates, the business decisions made in response to changes in that environment, the operating results of implementing those decisions, and the description of those results provided by the financial press and by financial statements.

Within Ryder's financial statements, many significant accounting issues are reported. These include ordinary income, unusual items, discontinued operations, extraordinary items, changes in accounting principles and revisions of estimates. Students experience the reporting of these items as well as certain strategic aspects of reporting, such as incentives to manage earnings.

RYDER System, Inc. was founded in 1955 by James A. Ryder. Under his leadership, the Miami-based company became a transportation-related services giant. After guiding the company for a number of years, though, he resigned in 1978 to begin a new business venture.

THE EXPANSION PHASE

Shortly after the founder's departure, M. Anthony Burns was promoted to the position of company president. In 1983, Burns was promoted again, to the position of chief executive officer. At the time he assumed these leadership roles, Burns believed Ryder was overly dependent on its highly cyclical trucking business. Therefore, one of his major goals was to

Kennard S. Brackney is Assistant Professor, and William A. Collins is Professor and Department Head, both at the University of North Carolina at Greensboro.

The analyses and exhibits presented in the case are prepared from publicly available data gathered from the financial press and Ryder System, Inc.'s annual reports for the years 1986–1991.

diversify the company's business activities. The result was an aggressive program of expansion and marketing. By the end of 1987, capital spending had risen to $1 billion per year; an additional $1 billion had been used to acquire approximately 100 companies; assets and revenues had tripled to $5.8 billion and $4.6 billion, respectively; and the numbers of vehicles and employees had doubled to 152,000 and 41,000, respectively.

Primarily through acquisitions, Ryder expanded into several additional transportation services markets. These markets included aircraft parts, maintenance, and leasing; mass transit bus fleet leasing and servicing; and school bus fleet leasing and servicing. By 1987, aviation services accounted for 21 percent of total revenue, and bus fleet leasing and servicing accounted for close to 7 percent. However, despite these diversification efforts, trucking services and automotive and freight hauling remained the most significant, accounting for almost 70 percent of 1987 revenue.

During this expansion phase, profitability was not sacrificed. On the contrary, Ryder prospered considerably during the early years of Burns' tenure as chief executive officer (Engardio 1987). During this phase, the company thrived in a climate of broad-based expansion in the economy, recent deregulation in the trucking industry, and a paralyzing power struggle at U-Haul International, Inc., Ryder's major competitor. In 1987, toward the end of the phase, Ryder enjoyed its seventh consecutive year of record earnings. During those seven years, growth in earnings averaged more than 15 percent per year.

THE RESTRUCTURING PHASE

In contrast, Ryder began to experience certain operating and financial difficulties in 1988 (Deveny 1988). The economic expansion of the mid-1980s was starting to slow. Production in the auto industry fell from the previous year, hurting Ryder's auto-hauling business. In addition, Ryder's principal competitor, U-Haul, implemented a program of modernization and price-cutting and recaptured some of its lost market share. Because of these developments, 1988 was a year of much slower growth for Ryder. Burns indicated some *fine-tuning* measures were needed to better balance the company's assets with the weaker market demand. Accordingly, acquisitions were reduced by one-third, other capital spending by eight percent, and $129 million of higher-interest cost debt was retired early. Based on these measures, Ryder looked forward to 1989 with cautious optimism.

However, 1989 also was a difficult year (Engardio 1989). The economy continued to slow, further depressing the demand for transportation services. Intensified price competition from U-Haul and others squeezed already thin profit margins. Some analysts believed the company was in need of a major restructuring (Waldman and Christie 1989). Their feelings were that efficiency and customer service may have been compromised during the period of focus on growth. Ryder responded with more substantial restructuring measures. Acquisitions and capital spending were cut again, by a combined seven percent. Several businesses, including the poor-fitting insurance management services division and the money-losing freight-hauling operation, were sold. As a result, nearly 3,000 employee positions were eliminated. Also, Ryder retired early an additional $253 million of higher-interest cost debt. Burns explained that the restructuring effort was aimed at refocusing the company on its core transportation services businesses.

In 1990, the economy slowed to a recessionary pace. Ryder's core businesses suffered heavily from a soft housing market and the lowest auto production since 1983. In response, Burns pushed ahead with a program of streamlining the company's operations. Capital spending was slashed by another 21 percent and the numbers of vehicles and employees reduced by 2,000 each. A plan to discontinue the highly variable aircraft leasing business was also announced. Burns attempted to assure the investment community that Ryder, in its leaner form, was prepared to survive the recession and positioned to grow once demand strengthened.

Unfortunately, the economy sank more deeply into recession in 1991. Ryder continued to feel the effects of this recession, especially in its truck rental businesses. Capital spending again was slashed, by 26 percent, which reduced the 1991 amount to approximately half the 1987 amount. The vehicle fleet was also slashed, this time by about 6,000. As a result of the downsizing program, year-end assets and long-term debt were 12 percent lower and 29 percent lower, respectively, than in 1987. Yet, despite all of the measures taken, the long-term prospects for Ryder System, Inc. remained uncertain at the end of 1991 (Fins 1991).

REPORTING THE RESULTS OF OPERATIONS

In addition to the analysis of Ryder System's changes in operations provided in the financial press, these operations were described by the company in its 1987–1991 consolidated statements of earnings and related notes that focused on operating activities.

In order to increase the usefulness of the information contained in the statement of earnings, different categories of income are prescribed under generally accepted accounting principles (GAAP). The major categories are (1) income from continuing operations (Accounting Principles Board (APB) Opinion No. 30 1973), (2) discontinued operations (APB Opinion No. 30), (3) extraordinary items (APB Opinion No. 30), and (4) the cumulative effect of a change in accounting principles (APB Opinion No. 20 1971). The category of discontinued operations is further subdivided into two subcategories, income (loss) from operations and gain (loss) on disposal (APB Opinion No. 30). Although GAAP does not require companies to report subcategories of income from continuing operations, the Financial Accounting Standards Board's Conceptual Framework as well as the actual reporting practices of companies suggest that such subcategories exist and are reported.[1] The two subcategories of income from continuing operations that are frequently reported are operating income and other revenues and expenses.

Ryder System, Inc.'s operations during the 1985–1991 period were sufficiently complex that each of these major categories and subcategories of income are contained in one or more of the annual consolidated statements of earnings issued or presented for comparative purposes by the company during that period. Abstracts of these statements and certain related notes are presented in exhibit 1.

QUESTIONS

After reviewing exhibit 1, please answer the following questions:

---

[1] In Statement of Financial Accounting Concepts No. 6, paragraph 77 (1985), the Financial Accounting Standards Board cites operating income as one of several examples of potentially meaningful components of comprehensive income. The 1993 *Accounting Trends & Techniques* (Shohet and Rikert 1993) indicates that 389 of the 600 survey companies report a multiple-step income statement. Of these companies, 230 (59 percent) report a subtotal for operating income.

EXHIBIT 1A
Selected Excerpts from the 1987–1989 Ryder System, Inc. Annual Reports

Consolidated Statements of Earnings
(thousands of dollars)

	Years ended December 31				
	1989	1988	1987	1986	1985
Revenue	$3,943,374	3,902,464	3,656,964	3,136,304	2,733,758
Net sales	1,130,054	1,127,106	952,096	632,024	171,529
Total revenue and net sales	5,073,428	5,029,570	4,609,060	3,768,328	2,905,287
Operating expense	3,148,900	3,009,201	2,826,322	2,404,890	2,105,194
Cost of sales	881,237	869,569	709,918	485,591	123,418
Depreciation, net of gains	625,198	602,877	541,724	425,481	325,181
Interest expense	270,900	267,347	242,723	191,985	156,741
Unusual charges	90,000	69,668	—	—	—
Miscellaneous income	(32,593)	(13,019)	(14,399)	(17,090)	(7,369)
	4,983,642	4,805,643	4,306,288	3,490,857	2,703,165
Earnings before income taxes, extraordinary item and cumulative effect of change in accounting	89,786	223,927	302,772	277,471	202,122
Provision for income taxes	37,597	89,269	115,659	116,538	76,806
Earnings before extraordinary item and cumulative effect of change in accounting	52,189	134,658	187,113	—	—
Extraordinary loss	(6,023)	(18,581)	—	—	—
Cumulative effect on prior years of change in accounting	—	81,096	—	—	—
Net earnings	**$ 45,986**	**197,173**	**187,113**	**160,933**	**125,316**

Related Notes Excerpted from the 1987–1989 Annual Reports*

Accounting Change (1986 and 1987)

In 1986, the company adopted Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions." This change increased 1986 net earnings $8.7 million ($0.12 per share).

Revenue Recognition (1987–1989)

Lease revenue, other transportation services revenue and aircraft and parts sales are recognized as earned.

Revenue-Earning Equipment, Operating Property and Equipment and Depreciation (1987–1989)

Revenue-earning equipment (principally vehicles) and operating property and equipment are stated at cost, net of purchase discounts. Provision for depreciation and amortization on substantially all depreciable assets is computed using the straight-line method.

EXHIBIT 1A (Continued)

Gains on operating property and equipment sales are reflected in miscellaneous income. Gains on sales of revenue-earning equipment excluding aircraft, net of costs incurred in preparing the equipment for sale, are reported as reductions of depreciation expense and totaled $21 million, $34 million, $32 million, $26 million and $49 million in 1989, 1988, 1987, 1986 and 1985, respectively.

Acquisitions and Dispositions (1987)

During 1986, the company sold Municipal Issuers Service Corporation, the principal companies comprising its Financial & Communications Services Division and one of its freight management businesses, none of which was a reportable segment. Included in miscellaneous income in 1986 is $12.9 million representing the net pretax gain on these transactions.

Pension Plans (1987)

Effective January 1, 1986, the company adopted the provisions of Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions" (SFAS 87). Pension cost for 1987 and 1986 and the related disclosures as of December 31, 1987 and 1986, were determined under the provisions of SFAS 87. Pension costs for 1985 were determined under the provisions of previous accounting principles. Total pension expense for 1987, 1986, and 1985 was as follows:

In thousands	1987	1986	1985
Company-administered plans	$ 7,829	509	14,240
Union-administered plans	20,726	19,689	16,727
	$ 28,555	20,198	30,967

Net pension expense for company-administered plans includes the following components:

In thousands	1987	1986
Present value of benefits earned during the year	$ 14,379	7,474
Interest cost on projected benefit obligation	12,925	9,515
Actual return on plan assets	(7,187)	(19,762)
Other, net	(12,288)	3,282
Net pension expense	$ 7,829	509

The following tables set forth the plans' funded status at December 31, 1987 and 1986:

In thousands	1987	1986
Plan assets at fair value	$194,878	181,288
Actuarial present value of service rendered to date:		
Accumulated benefit obligation, including vested benefits of $111,722 in 1987 and $114,430 in 1986	(129,709)	(132,563)
Additional benefit based on estimated future salary levels	(30,688)	(22,453)
Projected benefit obligation	160,397	155,016
Plan assets in excess of projected benefit obligation	$ 34,481	26,272

(Continued on next page)

EXHIBIT 1A (Continued)

A reconciliation of the company's accrued pension expense to the plans' funded status at December 31, 1987 and 1986 is as follows:

In thousands	1987	1986
Accrued pension expense	$ (5,133)	(1,621)
Unrecognized transition amount	51,007	54,049
Unrecognized net gains (losses)	(11,393)	(26,156)
Plan assets in excess of projected benefit obligation	$34,481	26,272

Income Taxes (1988)

Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes," was issued by the Financial Accounting Standards Board in December 1987. Statement 96 requires a change from the deferred method to the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Under Statement 96, the effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under the deferred method, deferred taxes were recognized using the tax rate applicable to the year in which the timing difference originated. The impact of a change in tax rates was recognized in income as the timing differences reversed.

The company adopted Statement 96 in 1988. The cumulative effect of the change in the method of accounting for income taxes as of January 1, 1988, increased net earnings $81 million and has been reported separately in the 1988 Consolidated Statement of Earnings. Earnings before extraordinary item and cumulative effect of change in accounting for 1988 would have been approximately $14 million ($0.17 per common share) higher if Statement 96 was not adopted. This amount represents primarily the impact of the change in tax rates that would have been recognized in the provision for income taxes under the deferred method and is included in the $81 million cumulative adjustment. Excluding the balance of the $81 million recognized as the cumulative effect of the change in accounting, the effect on net earnings of adopting Statement 96 was not material.

Unusual Charges (1988 and 1989)

Included in results for 1989 and 1988 are a number of unusual charges. The following table summarizes these charges:

In thousands	1989	1988
Business restructurings	$48,228	27,100
Revaluation of goodwill	8,772	42,568
Increase in estimated workers' compensation loss reserves for prior years	20,000	—
Other charges	13,000	—
	$90,000	69,668

In the first quarter of 1988, the company began restructuring its truckload carrier operation and recorded a downward adjustment to goodwill related to both truckload carrier and customs brokerage operations. In the fourth quarter of 1988, the company expanded its restructuring of the truckload carrier operation and began corporate-wide workforce reductions. In early January 1989, the company announced the reorganization of its Aircraft Services Division into two divisions. In February 1989, the company announced its intention to explore the sale of three business units, the truckload carrier operation (the assets of which were subse-

EXHIBIT 1A (Continued)

quently disposed of) and its customs brokerage and freight assembly and distribution operations, which were both sold. The write-down of goodwill and the total provision for business restructurings, covering losses on vehicle and facility disposals, employee severance costs and other miscellaneous costs reduced 1988 pretax earnings by $70 million.

The company recorded a number of unusual charges during the third quarter of 1989. These charges related primarily to anticipated losses on accelerated vehicle dispositions and staff and facility reductions, changes to estimated prior years workers' compensation loss reserves, the bankruptcy filing of Braniff Airlines, an Airline Services Division customer, the write-down of the carrying value of several small unprofitable businesses and the write-down of slow-moving rotable aircraft parts inventory. The impact of these charges was to decrease pretax earnings by $90 million.

Dispositions (1989)

During 1989, the company sold four business units, the largest of which were Insurance Management Services and Japan Fleet Service (an Aviation Services' business engaged in highly leveraged purchase-leaseback transactions). As a result of the sale of the four operations during 1989, a gain of $22 million was realized and reported in miscellaneous income.

Extraordinary Item (1988)

The extraordinary item in 1988, net of income tax benefit of $10 million, relates to the company's purchase, at a premium, of two series of unsecured notes totaling $158 million, which were due in 1994.

---

* With one exception, the notes presented in exhibit 1A were obtained from Ryder's 1987–1989 annual reports. The exception is the Accounting Change note, which was reported in the 1986 annual report. This note is included because it provides the only reference from Ryder's financial statements to the effect of adoption and initial application of SFAS 87 on 1986 income.

Certain of the notes presented in exhibit 1A combine information from notes found in two or more annual reports during the 1987–1989 period. In these cases, much of the wording in the yearly notes was identical for the various annual reports involved. The Revenue Earning Equipment, Operating Property and Equipment and Depreciation note presented is modified slightly to include data for all years, 1985–1989. Also, the Unusual Charges note presented is based on the fuller discussion found in the note in the 1989 annual report.

EXHIBIT 1B

Selected Excerpts from the 1990 and 1991 Ryder System, Inc. Annual Reports

Consolidated Statements of Earnings
(thousands of dollars)

	Years ended December 31			
	1991	1990	1989#	1988#
Revenue	$3,860,557	3,956,827	3,900,128	3,863,318
Net sales	1,200,539	1,205,506	1,130,054	1,027,575
Total revenue and net sales	5,061,096	5,162,333	5,030,182	4,890,893
Operating expense	3,193,354	3,240,775	3,141,467	3,005,088
Cost of sales	943,570	940,338	881,273	786,994
Depreciation, net of gains	603,415	616,082	601,955	581,117
Interest expense	206,481	234,923	257,765	252,244
Unusual charges	—	—	90,000	69,668
Miscellaneous income	(599)	(8,336)	(32,593)	(13,019)
	4,946,221	5,023,782	4,939,867	4,682,092
Earnings from continuing operations before income taxes	114,875	138,551	90,315	208,801
Provision for income taxes	49,155	56,335	37,877	84,195
Earnings from continuing operations	65,720	82,216	52,438	124,606
Earnings (loss) from discontinued operations	(51,703)	(39,536)	(249)	10,052
Earnings before extraordinary item and cumulative effect of change in accounting	14,017	42,680	52,189	134,658
Extraordinary loss	—	—	(6,203)	(18,581)
Cumulative effect on prior years of change in accounting	—	—	—	81,096
Net earnings	**$14,017**	**42,680**	**45,986**	**197,173**

Reclassified for the effects of the discontinued operation reported initially in 1990.

Related Notes Excerpted from the 1990 and 1991 Annual Reports*

Revenue Recognition (1990 and 1991)

Lease revenue, other transportation services revenue and aircraft and parts sales are recognized as earned.

Revenue-Earning Equipment, Operating Property and Equipment and Depreciation (1990 and 1991)

Revenue-earning equipment (principally vehicles) and operating property and equipment are stated at cost, net of purchase discounts. Provision for depreciation and amortization on substantially all depreciable assets is computed using the straight-line method.

EXHIBIT 1B (Continued)

Gains on operating property and equipment sales are reflected in miscellaneous income. Gains on sales of revenue-earning equipment (excluding aircraft) net of costs incurred in preparing the equipment for sale, are reported as reductions of depreciation expense and totaled $12 million, $9 million, $21 million and $34 million in 1991, 1990, 1989 and 1988, respectively. Losses related to the accelerated disposition of certain vehicles are not included in depreciation expense and are included in Unusual Charges in 1989.

Unusual Charges (1990 and 1991)

Included in results for 1989 and 1988 are a number of unusual charges. The following table summarizes these charges:

In thousands	1989	1988
Business restructuring	$48,228	27,100
Revaluation of goodwill	8,772	42,568
Increase in estimated workers' compensation loss reserves for prior years	20,000	—
Other charges	13,000	—
	$90,000	69,668

In the first quarter of 1988, the company began restructuring its truckload carrier operation and recorded a downward adjustment to goodwill related to both truckload carrier and customs brokerage operations. In the fourth quarter of 1988, the company expanded its restructuring of the truckload carrier operation and began corporate-wide workforce reductions. In early January 1989, the company announced the reorganization of its Aircraft Services Division into two divisions. In February 1989, the company announced its intention to explore the sale of three business units, the truckload carrier operation (the assets of which were subsequently disposed of) and its custom brokerage and freight assembly and distribution operations, which were both sold. The write-down of goodwill and the total provision for business restructurings, covering losses on vehicle and facility disposals, employee severance costs and other miscellaneous costs, reduced 1988 pretax earnings by $70 million.

The company recorded a number of unusual charges during the third quarter of 1989. These charges related primarily to anticipated losses on accelerated vehicle dispositions and staff and facility reductions, changes to estimated prior years workers' compensation loss reserves, the bankruptcy filing of Braniff Airlines, an Airline Services Division customer, the write-down of the carrying value of several small unprofitable businesses and the write-down of slow-moving rotable aircraft parts inventory. The impact of these charges was to decrease pretax earnings by $90 million.

Dispositions (1990)

During 1989, the company sold four business units, the largest of which were Insurance Management Services and Japan Fleet Service (an Aviation Services' business engaged in highly leveraged purchase-leaseback transactions). As a result of the sale of the four operations during 1989, a pretax gain of $22 million was realized and reported in "miscellaneous income."

Discontinued Operations (1990)

In February 1991, the company adopted a formal plan to discontinue its aircraft leasing business and commence an orderly sale of the business's 34 remaining aircraft and other assets. In connection with this decision, the company recorded an after tax charge of $36 million ($0.48 per common share) in the fourth quarter of 1990 to provide for the estimated loss on

(Continued on next page)

EXHIBIT 1B (Continued)

disposition of the aircraft and other assets. This charge included $7 million for anticipated operating losses from the business through the end of the estimated two-year disposition period. Recent adverse developments within the airline industry combined with the bankruptcy of the business's largest aircraft lessee and the default by several others on scheduled lease payments led to the decision. Prior years' financial statements have been restated to present this business as a discontinued operation.

Interest expense has been allocated to the discontinued business based upon an assumed debt to equity ratio consistent with other similar businesses and with the company's historical interest allocation method for segment reporting. Interest expense of $15 million, $13 million, and $15 million was allocated to discontinued operations for the years ended December 31, 1990, 1989, and 1988, respectively.

Operating results of the discontinued operation are summarized as follows:

In thousands	1990	1989	1988
Revenue and net sales	$121,154	43,246	138,667
Earnings (loss) from operations before income taxes and disposition loss	(6,240)	(529)	15,126
Income tax benefit (provision)	2,314	280	(5,074)
Earnings (loss) from operations before disposition loss	(3,926)	(249)	10,052
Estimated provision for loss on disposition	(55,000)	—	—
Income tax benefit	19,390	—	—
Net estimated loss on disposition	(35,610)	—	—
Earnings (loss) from discontinued operations	$(39,536)	(249)	10,052

Discontinued Operations (1991)

In the fourth quarter of 1990, the company discontinued its aircraft leasing business, which included aircraft and other assets. In connection with this decision, the company recorded an after-tax charge of $36 million ($0.48 per common share) to provide for the estimated loss on disposition of the aircraft and other assets. This charge included $7 million for anticipated operating losses from the business through the end of the planned disposition period.

Since year-end 1990, aircraft values dropped precipitously, aggravated by continued economic stress within the airline industry and the fourth-quarter shutdown of two airlines. Accordingly, the company increased its aircraft disposition loss estimates in the fourth quarter of 1991, resulting in an after-tax charge of $52 million ($0.70 per common share).

Extraordinary Items (1990 and 1991)

In 1988, the company repurchased two series of unsecured notes due in 1994 for $158 million creating an extraordinary loss of $19 million, net of tax benefits of $10 million. In the fourth quarter of 1989, the company exercised its option to call all of its outstanding collateral trust debentures and senior secured notes for early redemption creating an extraordinary loss of $6 million, net of tax benefits of $3 million. The total amount of debt called was $253 million, $30 million of which was retired during 1989. The balance of this debt was retired in early 1990.

* Certain of the notes presented in exhibit 1B combine information from notes found in both the 1990 and 1991 annual reports. In these cases, much of the wording in the yearly notes was identical for the two years. The Revenue Earning Equipment, Operating Property and Equipment and Depreciation note presented is modified slightly to include data for all years, 1988–1991. Also, both the Unusual Charges note and the Extraordinary Items note are based on the fuller discussions found in notes in the 1990 annual report.

Question 1

a. Operating income is a measure of a company's profitability as a result of its primary business activities. Other revenues and expenses, on the other hand, pertain to peripheral or incidental activities of a company. Significant unusual or infrequently occurring items are often included as part of other revenues and expenses as well.[2] Consequently, operating income, because of its emphasis on central operations and on usual and recurring transactions, is potentially a very useful measure for evaluating past performance and predicting future performance. For the transactions reported as income from continuing operations in the consolidated statements of earnings for 1985–1991, indicate which you would classify as operating income and which you would classify as other revenues and expenses. Explain your reasoning.

b. For the years 1985–1991, prepare schedules of the components of operating income by (1) amounts (in millions) and common size and (2) year-to-year percentage changes. Use these schedules to analyze the changes in operating income. What implications can you infer from this analysis?

Question 2

a. In both the 1988 and 1989 statements of earnings, Ryder reported certain transactions as unusual charges. In 1988, these charges included estimated losses related to (1) accelerated vehicle and facility disposals, (2) employee severance costs, and (3) write-downs of goodwill. In 1989, the unusual charges included estimated losses due to (1) accelerated sales of vehicles, (2) staff and facility reductions, (3) increases in compensation loss reserves, and (4) write-downs of receivables, inventories, and goodwill. Why are these adjustments reported as a part of income from continuing operations? Why are the estimated losses from the accelerated disposals of vehicles reported as unusual charges rather than as adjustments to depreciation?

b. Ryder initially reported a discontinued operation in the 1990 statement of earnings. What are the general criteria for classifying a disposal as a discontinued operation? What is the significance of the measurement date? When was the measurement date in this case? When did Ryder expect to complete this disposal? Why was Ryder disposing of this segment of its business?

c. In the 1989 and 1988 statements of earnings presented for comparative purposes in the 1990 annual report, discontinued operations were also reported. However, when the 1989 and 1988 statements of earnings were originally issued, neither statement contained a provision for discontinued operations. Why are the effects of a discontinued operation initially reported in the current year also reported as discontinued operations in financial statements for previous years presented for comparative purposes?

d. In the 1991 statement of earnings, Ryder reported an after-tax charge of $52 million under discontinued operations. What justification exists for reporting this charge under discontinued operations?

---

[2] APB Opinion No. 30 defines *unusual nature* as unrelated or only incidentally related to the typical activities of the business and *infrequency of occurrence* as not expected to recur in the foreseeable future. For a more detailed examination of these terms, including the rather subtle distinction between them, see Hendriksen and Van Breda (1992, 324–329).

e. In addition to the disposal of the aircraft leasing business initially reported in 1990, Ryder included a $12.9 million pretax gain from the sale of business units in miscellaneous income in 1986 and a $22 million pretax gain from the sale of business units in miscellaneous income in 1989. Why were these gains from sales of the business units included in miscellaneous income rather than as discontinued operations?

Question 3

a. Ryder reported extraordinary losses in both its 1988 and 1989 statements of earnings. What are the general criteria for classifying a gain or loss as extraordinary? Do the extraordinary losses reported by Ryder meet these general criteria? Do you agree that these losses are correctly classified?

b. When an extraordinary loss on retirement of debt is reported, what can you infer about the relationship between the market rate of interest when the debt was issued and the market rate when the debt was retired?

c. Why do you believe Ryder retired these debt issues? Do the extraordinary losses reported indicate that Ryder simultaneously experienced economic losses from the debt retirements? Please explain your response.

Question 4

a. A change in accounting principles occurs when a company changes from one acceptable method of accounting to another acceptable method. The new method may be described in an existing pronouncement or a newly issued pronouncement. When a change is made to a method described in an existing pronouncement, this change is elective. In general, how should a company report this type of change? What is the usual justification for making this type of change? Is this justification required to be disclosed?

b. When a change is made to a method described in a newly issued pronouncement, this change is usually required. However, it is elective if there is an adoption of the pronouncement prior to its effective date (i.e., an early adoption). How should changes to newly issued pronouncements be reported? Is justification for adoption of a newly issued pronouncement required to be disclosed? Is justification for *early* adoption of a newly issued pronouncement required to be disclosed?

c. In 1986, Ryder adopted early the provisions of Statement of Financial Accounting Standards No. (SFAS) 87 (1985), *Employers' Accounting for Pensions*. In 1988, Ryder adopted early the provisions of SFAS 96 (1987), *Accounting for Income Taxes*. Compare the manner in which these changes in accounting principles were reported in the 1986 and 1988 statements of earnings. Were they reported correctly?

d. What motivation might have existed for Ryder's early adoptions of these accounting methods?

TEACHING NOTES

In the Ryder System, Inc. case, the reporting of operations in a series of income statements is framed within business decision contexts. The information contained in the financial statements is also framed within the information provided to the market by other sources. The objectives of these framings are to provide students with a richer appreciation of the environment in which a business operates, the business decisions made in reaction to changes in that environment, the operating results of implementing those decisions, and the description of those operating results provided by different sources of information to the market.

We initially developed the case for an introductory financial accounting course for MBA students. Because of the positive student reaction, we subsequently incorporated it into an intermediate accounting course presented to undergraduate students. In both situations, the strategy employed is to use the case as the final step in a series of lectures on *reporting the results of operations*. These lectures initially are based on standard textbook treatment of the major components of net income—income from continuing operations, discontinued operations, extraordinary items, and the cumulative effect of a change in accounting principles. As each component is discussed, excerpts of income statements illustrating that component taken from recent editions of *Accounting Trends & Techniques* are presented for analysis. These excerpts and the related notes are further used to generate discussions about the business and accounting decisions underlying the transactions. Invariably these discussions result in one or more students raising issues about the possibilities of a company managing its earnings through business and accounting decisions.

At this time, academic articles such as "The Effect of Firms' Financial Disclosure Strategies on Stock Prices" (Healy and Palepu 1993) and "Evidence of Earnings Management by the Early Adopters of SFAS 96" (Gujarathi and Hoskin 1992) are incorporated to enrich the discussions. As the final step, the Ryder System case is assigned to frame the discussions within the environment in which a business operates, the business decisions made in reaction to changes in that environment, the operating results of implementing those decisions, and the description of those operating results provided by different sources of information to the market. Our experience is that the best results are obtained by assigning the case to student groups, who are required to prepare to discuss the case in class and submit written responses to the questions.

Because the students' knowledge of accounting varies, we find it beneficial to provide different guidance to different classes. Generally, we provide more explicit discussion of the accounting issues and accounting procedures to the MBA students, thus allowing them to focus more directly on the management issues. We also provide explicit guidance to the accounting majors when they have not yet been exposed to certain accounting subjects in their intermediate accounting courses.

DISCUSSION OF QUESTIONS

Question 1

a. With the exception of miscellaneous income, which was included among the expenses and losses, Ryder reported earnings from continuing operations in a single-step format in its consolidated statements of earnings for 1985--1991. Therefore, the transactions that Ryder classified as operating income are not as readily apparent as they would be in a multiple-step format for which a subtotal for operating income is often reported. Within this subtotal, most companies would include transactions reported by Ryder as revenue, net sales, operating expense, cost of sales, and depreciation (net of gains and losses). Most companies would exclude transactions reported by Ryder as unusual charges. Therefore, the transactions for which questions exist about their inclusion in operating income are interest expense and miscellaneous income.

Practice varies with respect to the classification of interest expense (Nurnberg 1983). We believe interest expense relates more to financing activities than to central operations, and we therefore exclude it from operating income in our analysis of operating income in Question 1(b).[3]

Miscellaneous income is a category used to combine items not sufficiently material to warrant disclosure as separate line items. Within this category, Ryder discloses two components: gains from sales of operating property and equipment as described annually in the summary of significant accounting policies and gains from sales of certain business units as described in notes to both the 1986 and 1989 financial statements. Ryder appears to consider both types of transactions as peripheral to their central operations. This is consistent with Nurnberg's (1983) observation that most companies that report both disposal gains (losses) and a subtotal for operating income exclude the disposal gains (losses) from the operating income subcategory. We, therefore, exclude miscellaneous income from operating income in our analysis in Question 1(b).[4]

b. A schedule of the amounts of the components of operating income and their size relative to total revenue and net sales is provided in exhibit 2. This schedule is presented for 1985–1989 and 1988–1991 because the discontinued operation reported initially in the 1990 financial statements resulted in the reclassification of the statements of consolidated earnings for 1989 and 1988 presented for comparative purposes with the 1990 financial statements. Thus, presentations for the years 1985–1989 and 1988–1991 are necessary because the 1989 and 1988 consolidated statements of earnings are available on both *initially reported* and *reclassified* bases. A schedule of the year-to-year percentage changes in the components of operating income is provided in exhibit 3. Consistent with the dual presentation of the reclassified years (i.e., 1989 and 1988) in exhibit 2, two different sets of percentage changes are presented for the year 1989 in exhibit 3.

An analysis of the amounts and relative values of the components of operating income for the years 1985–1989 (exhibit 2A) reveals that revenue increased during these years from $2.7 billion in 1985 to $3.9 billion in 1989, an increase of 44 percent. Because Ryder did not disclose any information on the effects of acquisitions on reported revenue, it is difficult to determine whether this growth was attributable to business combinations, increasing sales volume independent of business combinations, or both. Net sales increased from 6 percent of total revenue and net sales in 1985 to 22 percent in 1989; cost of sales increased from 4 percent to 17 percent of total revenue and net sales over the same period. As indicated in the notes to the financial statements, net sales and cost of sales

[3] We also perform an analysis of operating income with interest expense included. The interpretation of the analysis of operating income is not materially affected.

[4] We also perform an analysis of operating income with the gains from sales of operating property and equipment, which appear to be usual and recurring in nature, included. The interpretation of the analysis of operating income is not materially affected.

EXHIBIT 2A
Schedule of Operating Income—
Amounts (*in millions*) and Relative Values
For the Years Ending December 31, 1985–December 31, 1989

	1989		1988		1987		1986		1985	
	$	%	$	%	$	%	$	%	$	%
Revenue	3,943	78	3,902	78	3,657	79	3,136	83	2,734	94
Net sales	1,130	22	1,127	22	952	21	632	17	172	06
Total revenue and net sales	5,073	100	5,030#	100	4,609	100	3,768	100	2,905#	100
Operating expense	3,149	62	3,009	60	2,826	61	2,405	64	2,105	72
Cost of sales	881	17	870	17	710	15	486	13	123	04
Depreciation, net of gains	625	12	603	12	542	12	425	11	325	11
Total operating expenses	4,655	92#	4,481#	89	4,078	88	3,316	88	2,554#	88#
Operating income	418	08	548#	11	531	12	452	12	351	12

#Due to rounding methods, these figures do not equal exactly the sum (difference) of the figures above them.

EXHIBIT 2B
Schedule of Operating Income—
Amounts (*in millions*) and Relative Values
For the Years Ending December 31, 1988–December 31, 1991

	1991		1990		1989*		1988*	
	$	%	$	%	$	%	$	%
Revenue	3,861	76	3,957	77	3,900	78	3,863	79
Net sales	1,201	24	1,206	23	1,130	22	1,028	21
Total revenue and net sales	5,061#	100	5,162#	100	5,030	100	4,890#	100
Operating expense	3,193	63	3,241	63	3,141	62	3,005	61
Cost of sales	944	19	940	18	881	18	787	16
Depreciation, net of gains	603	12	616	12	602	12	581	12
Total operating expenses	4,740	94	4,797	93	4,625#	92	4,373	89
Operating income	321	06	365	07	405	08	517	11

* In Ryder's statement of earnings for the year ending December 31, 1990, the statements of earnings presented for comparative purposes (i.e., for the years ending December 31, 1989 and 1988) are reclassified for the effects of the discontinued operation reported initially in 1990. As a result, the amounts and relative values of the components of operating income for 1989 and 1988 are available on both *initially reported* and *reclassified* bases. The amounts and relative values for the initially reported basis are presented in exhibit 2A; the amounts and relative values for the reclassified basis are presented in exhibit 2B.

\# Due to rounding methods, these figures do not equal exactly the sum (difference) of the figures above them.

EXHIBIT 3
Schedule of Operating Income—
Percentage Changes
For the Years Ending December 31, 1986–December 31,1991

	1991	1990	1989*	1989	1988	1987	1986
Revenue	–02	01	01	01	07	17	15
Net sales	00	07	10	00	18	51	268
Total revenue and net sales	–02	03	03	01	09	22	30
Operating expense	–01	03	05	05	06	18	14
Cost of sales	00	07	12	01	22	46	293
Depreciation, net of gains	–02	02	04	04	11	27	31
Total operating expenses	–01	04	06	04	10	23	30
Operating income	–12	–10	–22	–24	03	13	29

* In Ryder's statement of earnings for the year ending December 31, 1990, the statements of earnings presented for comparative purposes (i.e., for the years ending December 31, 1989 and 1988) are reclassified for the effects of the discontinued operation reported initially in 1990. As a result, percentage changes in the components of operating income for 1989 are available on both *initially reported* and *reclassified* bases. Accordingly, the percentage changes for both bases are included here.

relate to sales of aircraft and aircraft parts. Depreciation as a percentage of total revenue and net sales increased only slightly over the period. Operating expense as a percentage of total revenue and net sales declined, though not by enough to offset the increase in cost of sales. As a result, total operating expenses increased from 88 percent of total revenue and net sales in 1985 to 92 percent in 1989. Operating income fell from 12 percent in 1985 to 8 percent in 1989.

An analysis of the amounts and relative values of the components of operating income for the years 1988–1991 (exhibit 2B) indicates comparatively little change occurred during this period, especially after 1989. Revenue remained essentially flat. Net sales increased to 24 percent of total revenue and net sales in 1991; cost of sales increased to 19 percent. Operating expense increased slightly as well, rising to 63 percent in 1991. As a result, total operating expenses rose to 94 percent of total revenue and net sales in 1991, and operating income fell to just 6 percent.

An analysis of the year-to-year percentage changes in the components of operating income for 1986 and 1987 (exhibit 3) indicates that net sales and cost of sales increased dramatically in these years, especially in 1986. These categories increased by 268 and 293 percent, respectively, from 1985 to 1986, and by 51 and 46 percent, respectively, from 1986 to 1987. The significant increases in these items were most likely attributable to new companies being acquired by Ryder at that time.[5] However, the analysis also indicates a downturn in the overall growth

[5] In November 1985, Ryder acquired Availl, Inc., a company engaged in the maintenance of aircraft engines and in the worldwide distribution of engine and aircraft parts and supplies. Also, in December 1986, Ryder acquired the aircraft parts distribution business of Van Dusen Air Incorporated.

rate being experienced by Ryder. For example, total revenue and net sales increased by 30 percent from 1985 to 1986, but only by 22 percent from 1986 to 1987. Total operating expenses increased by 30 percent from 1985 to 1986 also, and by 23 percent from 1986 to 1987. As a result of the slightly greater growth in 1987 in the total operating expenses, particularly in cost of sales and depreciation, the rate of growth in operating income declined from 29 percent from 1985 to 1986 to 13 percent from 1986 to 1987.

An analysis of percentage changes in the components of operating income for 1988 and 1989 (as initially reported) confirms the downturn in overall growth. The rate of growth in total revenue and net sales declined to 9 percent from 1987 to 1988 as compared to the 30 percent growth from 1985 to 1986 and 22 percent growth from 1986 to 1987. Growth in operating expense and depreciation decreased as well, but cost of sales grew by 22 percent, a rate faster than the increase in net sales. As a result, total operating expenses increased by 10 percent from 1987 to 1988, and operating income increased by just 3 percent.

Growth in operating expense, cost of sales, and depreciation slowed further in 1989. Total operating expenses grew by only 4 percent. However, total revenue and net sales increased by only 1 percent from 1988 to 1989. As a consequence, operating income dropped by 24 percent. (These results are consistent with those obtained from an analysis of the percentage changes in the components of operating income (reclassified) for 1989.)

An analysis of percentage changes in the components of operating income for 1990 and 1991 indicates that Ryder was still mired in the downturn. Total revenue and net sales increased by only 3 percent from 1989 to 1990, while total operating expenses increased by 4 percent. Total revenue and net sales actually decreased by 2 percent from 1990 to 1991, and total operating expenses decreased by 1 percent. The result was that operating income fell by 10 percent in 1990 and by an additional 12 percent in 1991.

The implications of these analyses are that Ryder reached the end of a growth cycle in 1987 or 1988, experienced a downturn in its ongoing operations, and resided in a no-growth phase at the end of 1991.

Question 2

a. Income from continuing operations includes both operating income and other significant items that are peripheral and/or either unusual or nonrecurring. The other significant items are classified as income from continuing operations because they do not meet the criteria requiring them to be classified as either discontinued operations or extraordinary items. The adjustments reported by Ryder in its 1988 and 1989 statements of earnings do not qualify as discontinued operations because they relate to business activities in which Ryder continues to be engaged. They do not qualify as extraordinary items because they are not both unusual and nonrecurring. Thus, they are properly classified as components of income from continuing operations. These adjustments are reported as separate line items to highlight them as unusual charges and to differentiate them from transactions subclassified as operating income.

These unusual charges include the estimated losses from accelerated disposals of vehicles. Consistent with a group or composite method of depreciation, Ryder reports net gains from usual and recurring sales of vehicles as adjustments of depreciation expense. Because the accelerated dispositions of vehicles are made as a part of Ryder's program to restructure its operations, these dispositions are nonrecurring in nature and are reported as unusual charges to differentiate them from gains and losses arising from the recurring sales.[6]

b. A discontinued operation involves a segment of the business that represents a complete and separate major line of business or class of customer. In addition, the segment's assets, results of operations, and activities should be clearly distinguishable—physically, operationally, and for financial reporting purposes. The measurement date is the date on which a company commits to a formal plan to dispose of a segment. The measurement date is also pivotal to the prescribed accounting for discontinued operations. Within the discontinued operations classification, (1) the results of operations of the segment prior to the measurement date are subclassified as income (loss) from operations, and (2) the expected results of operations of the segment from the measurement date to the disposal date, the expected amount of gain (loss) to be realized at the expected disposal date, plus any additional estimated costs and expenses directly related to the disposal, are subclassified as gain (loss) on disposal. A loss on disposal should be recognized at the measurement date; a gain on disposal should be recognized when realized.

In Ryder's case, the notes to the 1990 financial statements identify the measurement date as February 1991.[7] Outwardly, this date suggests that the discontinuance of the segment should have been reported in Ryder's 1991 financial statements, but Ryder chose to report the discontinuance in its 1990 financial statements. APB Opinion No. 30 (1973), which governs the reporting of discontinued operations, indicates that if financial statements for a date prior to the measurement date of a discontinued operation have not yet been issued (as is the case here), those statements should be adjusted to reflect the effects of Type I subsequent events related to the discontinuance. A Type I subsequent event is an event or transaction occurring after the financial statement date, but before the financial statements are issued, that provides additional information concerning conditions that existed at the financial statement date (Statement on Auditing Standards No. 1 1972). Ryder's including the discontinuance in its 1990 financial statements is consistent with the view that the plan to discontinue the segment is

[6] A potential question that could arise is whether Ryder's reporting of gains on some disposals of vehicles as adjustments of depreciation expense and losses on other disposals as unusual charges represents a reporting abuse designed to maximize the income subcategory operating income. That is, perhaps Ryder was classifying these gains and losses not on the basis of the nature of the disposal transactions, but on the basis of their gain/loss status. If this were the case, one would expect to find disposal losses on vehicles reported as unusual charges in years without restructuring of operations. An examination of the financial statements for the years 1985–1992 shows that the only years in which Ryder reported losses from disposals of vehicles as unusual charges were 1988 and 1989. As noted in the text, in these years, Ryder incurred losses on accelerated disposals of vehicles made as part of its program of restructuring. Thus, an assertion that Ryder was engaging in a reporting abuse is not supported.

[7] A discrepancy exists in the identification of the measurement date in the notes to the 1990 and 1991 financial statements. The Discontinued Operations note to the 1990 statements identifies the measurement date as February 1991; the Discontinued Operations note to the 1991 statements identifies the measurement date as the fourth quarter of 1990. The note to the 1990 statements refers to when Ryder adopted the formal plan of disposal. The note to the 1991 statements refers to when Ryder recognized the discontinuance (viewed as a Type I subsequent event) for accounting purposes.

more representative of a condition which existed at year-end than of a condition which arose after year-end.

However, Ryder's reporting the $40 million loss from the discontinued operation in its 1990 financial statements rather than in its 1991 financial statements is also consistent with earnings management behavior. One form of earnings management behavior is when a company elects to report all of its *bad news* in order to put this news behind it. This form of earnings management is commonly referred to as the *big bath* approach (Copeland and Moore 1972; Elliott and Shaw 1988). Big baths often occur when (1) the company's operations are being restructured, (2) the company is experiencing a downturn in earnings, and/or (3) market analysts' earnings expectations are relatively low. Thus, Ryder may have chosen to report the discontinuance in 1990 so as to report a higher income from continuing operations in 1990 and a higher net income in 1991.

The notes to the 1990 financial statements indicate the disposal period was expected to extend for two years. While APB Opinion No. 30 indicates that a disposal period longer than one year would be considered unusual, it does not prohibit a longer period. However, Staff Accounting Bulletin (SAB) No. 93, *Accounting and Disclosures Relating to Discontinued Operations*, issued in 1993, requires companies under the jurisdiction of the Securities Exchange Commission to comply with a one-year disposition period.[8] Thus, while Ryder was permitted to use a two-year disposition period in its 1990 financial statements, as a publicly-held company, it would no longer be permitted to do so.

A major reason for the issuance of SAB 93 was the potential misuse of APB Opinion No. 30 by companies who wished to accelerate write-offs of estimated operating losses for extended future periods to allow them to report increased income when they issued financial statements for those future periods. Ryder's $7 million estimate of operating losses for the two-year disposition period was approximately 19 percent of the $36 million estimated total loss on disposal. Assuming a pro-rata allocation, the additional year would have accounted for approximately $3.5 million, or 10 percent of the total loss. Thus, there is little evidence that Ryder was attempting to manage its earnings by accelerating write-offs of future operating losses.

The discontinuance of the aircraft leasing segment of the business was consistent with Ryder's re-focusing its operations back to its core businesses. As indicated in the notes to the 1990 financial statements, the segment had moved from being profitable in 1988 to being unprofitable in 1989 and 1990 with further operating losses expected during the period of disposal.

c. In addition to disclosing discontinued operations in the year in which the decision to dispose is made (or in the preceding year if the financial statements were not yet issued), the financial statements for all years presented must also reclassify as discontinued operations the results of operations of the discontinued segment that were previously reported as income from continuing operations. This reclassification is made to provide comparable information. The results of the reclassification are aggregated and reported under the subcategory, income (loss)

[8] As part of its project on accounting for business restructurings, the Emerging Issues Task Force (EITF) is considering extending the one-year requirement to all companies (see EITF Issue No. 94-3). However, as of December 1994, no decision had been reached.

from discontinued operations. Thus, the 1989 and 1988 statements of earnings presented for comparative purposes with the 1990 statement are reclassified to separately disclose the operations of the segment discontinued in 1990.

d. As indicated in the note to the 1991 financial statements, the $52 million charge to discontinued operations resulted from changes in the airline industry arising after year-end 1990. Since this adjustment arises from information not available at the measurement date, it is classified as a change in estimate properly reported as an additional loss from disposal in the period in which the new information became available.

e. The inclusions of the $12.9 million and the $22 million pretax gains in miscellaneous income in 1986 and 1989, respectively, are appropriate since these dispositions of business units do not meet the criteria to be classified as discontinued operations. They do not meet the criteria for discontinued operations because the individual units only constitute a portion of a business segment and/or are not major in size. APB Opinion No. 30 requires this latter test, a materiality test, to be met by each business unit. The Opinion specifically proscribes combining unrelated assets to meet this test. Thus, these gains are reported pretax as components of income from continuing operations. Within the income from continuing operations classification, gains from peripheral or nonrecurring activities are generally included by Ryder in miscellaneous income.

Question 3

a. The general criteria for classifying a gain or loss as extraordinary are that the event or transaction giving rise to the gain or loss must be both unusual in nature and infrequent in occurrence in the environment in which the enterprise operates (APB Opinion No. 30 1973). The extinguishments of debt by Ryder do not meet the general criteria because extinguishments of debt by a corporation similar to Ryder are neither unusual nor infrequently occurring. However, in addition to the general criteria, there are certain transactions for which a resultant material gain or loss is classified as extraordinary without regard to the general criteria. These transactions include the extinguishment of debt (SFAS 4 1975) and the sale of significant assets previously recorded in a pooling of interests consummated in the prior two years (APB Opinion No. 16 1970). Thus, the losses reported in both 1988 and 1989 are correctly classified as extraordinary because they arise from early extinguishments of debt.

b. When debt is extinguished, an extraordinary item is reported for the difference between the book value of the debt and the cost of retiring it. The book value of long-term debt is the present value of its future cash flows *discounted at the market rate of interest when the debt was issued* plus any unamortized issuance costs. If debt is extinguished by repurchase in the market, the cost of retiring it is its current market price (i.e., the present value of its future cash flows *discounted at the current market rate of interest*) plus any related costs. If debt is extinguished by exercise of a call option, the cost of retiring it is its call price plus any related costs. The direction of movement in the market rate of interest can be inferred from the gain or loss on extinguishment only when the extinguishment is by means of a market repurchase. The reason is that the call price of debt is not necessarily the same as its current market price. The debt extinguished by Ryder in 1988 was by means of a market repurchase, while the debt extinguished in

1989 was by means of a call.[9] Drawing upon the well-known inverse relation between the market rate of interest and the value of debt, the loss on the 1988 extinguishment indicates that Ryder paid off debt issued when the market interest rate was higher than the current market rate.[10]

c. Early retirement of higher-interest rate debt may be undertaken for various reasons. These include reducing the amount of debt recorded on the balance sheet, reducing the amount of interest expense on future periods' income statements, reducing cash flows associated with future periodic interest payments, and increasing financial flexibility by eliminating the need to satisfy loan covenants. During the time frame in which the extinguishments took place, Ryder was restructuring its operations. Restructuring of operations often results in a reduced asset base, which, in turn, may reduce the level of financing that is needed. Debt financing, a more risky form of financing than equity financing, may be particularly sensitive to a restructuring of operations. Thus, the extinguishments of high-cost debt appear to be the results of accepted business decisions that are consistent with restructuring.

   The economic loss associated with a decrease in the market rate of interest occurs at the time the interest rate decreases. The loss is reported for accounting purposes gradually over the remaining term of the debt through higher than market interest expense. When the debt is retired early, as in this case, the portion of the loss which has not yet been recognized for accounting purposes is recognized in full at the time of the retirement. Thus, the extraordinary losses reported by Ryder relate to economic losses which had already occurred. An unresolved issue remains whether debt retirement, *per se*, triggers any additional economic gains or losses.

Question 4

a. In general, when a company voluntarily changes from one acceptable method of accounting to another acceptable method, the effect of the change on prior years' income (i.e., the transition amount) should be reported as the cumulative effect of a change in accounting principles (APB Opinion 20 1971). The cumulative effect is a catch-up adjustment reported net of taxes in the period of change as a

---

[9] In 1988, Ryder repurchased in the open market unsecured notes due in 1994 with a book value of $129 million for $158 million, resulting in an after-tax loss of $19 million. The interest rates on this debt ranged from 13.375 percent to 14 percent. Ryder's 1988 annual report indicates this debt retirement was financed through the issuance of lower-interest rate debt (p. 30). Late in 1989, Ryder exercised a call option on collateral trust debentures and senior secured notes with a combined book value of $253 million, resulting in an after-tax loss of $6 million. Though the 1989 annual report does not provide much detailed information on the debt retired early, an article in *The Wall Street Journal* indicates that the interest rates on this debt ranged from 9.25 percent to 13.75 percent and that the retirement would be financed partly with debt issued at lower costs ("Ryder System Sets Early Redemption of Nine Debt Issues").

[10] An alternative explanation for a gain or loss from retirement of debt is that, holding the market rate of interest constant, the company's risk and, therefore, discount rate changed from the time the debt was issued. For example, a loss from retirement of debt could also be attributable to a decrease in the company's risk and discount rate. This does not appear to be the case for Ryder's debt retirements in 1988 and 1989. Ryder's risk premium appears to be *increasing* during these years, as indicated by Moody's downgrading of $2.5 billion of the company's debt in 1989, and Standard & Poors Corp. placing about $2 billion of the company's debt on its CreditWatch list ("Ryder System Sets Early Redemption of Nine Debt Issues").

major category of income. When a change is made to another acceptable method, the justification for making this change must also be disclosed. The most common justification is that the new method is preferable, and preferable is usually described as providing a better measurement of income.

b. In contrast, when a company changes to a method of accounting prescribed by a newly issued pronouncement, the pronouncement will prescribe the effective date by which the change should be implemented and the manner in which the change should be reported. New pronouncements typically encourage companies to adopt the newly prescribed method prior to the effective date. Whether adopted early or not, the pronouncement itself is considered sufficient justification for the change. Since additional justification is not required, a company changing to the newly prescribed method is not required to disclose justification for the change. Likewise, disclosure of the reason(s) for an early adoption is also not required.

c. Ryder's adoption of SFAS 87 in 1986 is disclosed in both the Accounting Change note included in the *Summary of Significant Accounting Policies* and the Pension Plans note. The Pension Plans note further discloses that the adoption of SFAS 87 resulted in a transition gain that was being amortized as a component of periodic pension expense. In contrast, the adoption of SFAS 96 is reported on the 1988 statement of earnings as a transition gain, classified as a cumulative effect of a change in accounting principles, and also disclosed in the Income Taxes note.

To determine whether these changes were reported correctly, the pronouncements prescribing the new methods were examined. These pronouncements prescribe different methods of reporting the accounting changes. SFAS 87 prescribes a single approach, whereby a transition amount is computed and amortized to income prospectively over future periods, generally fifteen years or more. In contrast, SFAS 96 allows the transition amount to be reported as a cumulative effect in the year of transition or as a restatement. Most companies (including Ryder) that adopted SFAS 96 reported a transition gain, not a transition loss, and reported the transition gain as a cumulative effect in the year of transition. Therefore, both changes were reported correctly.

Ryder adopted both pronouncements early. For public enterprises, such as Ryder, SFAS 87 was effective for fiscal years beginning after December 15, 1986. Ryder adopted its provisions effective January 1, 1986, one year earlier than required. When issued, SFAS 96 was effective for fiscal years beginning after December 15, 1988.[11] Ryder adopted its provisions effective January 1, 1988, also one year earlier than required.

d. Since Ryder changed to methods of accounting prescribed by newly issued pronouncements, disclosures of the justifications for the changes or for the early adoptions were not required and were not presented. Therefore, the reason(s) for these early adoptions can only be speculated. Two of the principal reasons for a company electing to adopt early a mandated change in accounting are (1) the new method is preferable, and/or (2) the company is engaging in managing its earnings. As indicated before, preferable generally means that the new method of accounting provides a better measurement of earnings. Management of earnings in this context refers to the election of an accounting principle because it

[11] The effective date of SFAS 96 was delayed three times for a total of four years (by SFASs 100 1988; 103 1989; and 108 1991). SFAS 96 was ultimately replaced by SFAS 109 (1992) before it became effective.

has a planned effect on reported accounting earnings (Elliott and Philbrick 1990; Gujarathi and Hoskin 1992).

In addition to the disclosure of the early adoption of SFAS 87 in 1986, the Pension Plans note provides information about the funding status of the plan and the components of pension expense. This information indicates that the company-administered plans were overfunded, resulting in a transition gain in excess of $54 million. It further indicates that Ryder's pension expense is the net effect of several components, some of which are positive and some of which are negative. The Accounting Change note in the 1986 *Summary of Significant Accounting Policies* discloses that the initial application of SFAS 87 increased 1986 net earnings by $8.7 million. This amount represents approximately 6 percent of Ryder's 1986 net earnings computed before the effect of the newly adopted method. It also represents approximately 24 percent of the increase in net earnings from 1985 to 1986.

While the approximately $3 million amortization of the transition gain explains part of the decrease in pension expense measured in accordance with SFAS 87 as compared to APB Opinion No. 8 (1966), the reason(s) for the remaining decrease in pension expense in 1986 is not disclosed in either the Accounting Change or the Pension Plans notes. These notes also do not disclose whether pension expense determined in accordance with SFAS 87 as compared with APB Opinion No. 8 would continue to be less. Thus, the information disclosed provides limited basis for explaining why Ryder adopted SFAS 87 one year earlier than required. It is only possible to observe that the early adoption allowed Ryder to report higher income in the year of adoption.[12]

The effect of adopting SFAS 96 is disclosed on the face of the 1988 statement of earnings as an $81 million cumulative effect of a change in accounting. The Income Taxes note indicates the application of SFAS 96 in 1988 reduced income before continuing operations by $14 million. The note refers to this amount as being immaterial. However, since the effect represents six percent of income from continuing operations computed before the effect of the newly adopted method, the effect could have been classified as material. Regardless of the classification, the bulk of the impact of adopting SFAS 96 is contained in the cumulative effect that increased reported earnings by $81 million.[13] With this increase, 1988 net income ($197 million) was greater than 1987 net income ($187 million), and an upward trend in reported net income was continued. Without the $81 million increase, reported net income would have been significantly lower in 1988, particularly due to the restructuring and revaluation of goodwill losses reported in income from continuing operations and the extinguishment of debt loss reported as an extraordinary item. Thus, Ryder's early adoption of SFAS 96 may have been

---

[12] The favorable effect of adopting SFAS 87 on earnings might also be attributable to either changed demographics or to Ryder's use of more conservative actuarial cost methods or assumptions under APB 8 than under SFAS 87.

[13] The $81 million favorable cumulative adjustment effect of the change from APB Opinion No. 11 (1967) to SFAS 96 is consistent with the measurement by Ryder of its deferred tax liabilities using the lower 34 percent tax rate for 1988 and later years rather than the higher 40, 46 and 48 percent tax rates of earlier years when the deferred tax credits were initially recognized under APB Opinion No. 11. The $14 million unfavorable effect of adopting SFAS 96 on current year earnings is consistent with the accounting by Ryder for high-tax-rate timing differences reversing in 1988 in accordance with the gross change method under APB Opinion No. 11 had SFAS 96 not been adopted.

motivated to offset those reported losses and to continue the upward trend in reported net income.

REFERENCES

Accounting Principles Board. 1966. *APB Opinion No. 8: Accounting for Costs of a Pension Plan*. New York, NY: AICPA.

———. 1967. *APB Opinion No. 11: Accounting for Income Taxes*. New York, NY: AICPA.

———. 1970. *APB Opinion No. 16: Business Combinations*. New York, NY: AICPA.

———. 1971. *APB Opinion No. 20: Accounting Changes*. New York, NY: AICPA.

———. 1973. *APB Opinion No. 30: Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions*. New York, NY: AICPA.

American Institute of Certified Public Accountants. 1972. *Statement on Auditing Standards No. 1: Codification of Auditing Standards and Procedures*. New York, NY: AICPA.

Copeland, R. M., and M. L. Moore. 1972. The financial bath: Is it common? *MSU Business Topics* (Autumn): 63–69.

Deveny, K. 1988. Suddenly, Ryder is stuck in neutral. *Business Week* (October 10): 41–42.

Elliott, J. A., and D. R. Philbrick. 1990. Accounting changes and earnings predictability. *The Accounting Review* (January): 157–174.

———, and W. H. Shaw. 1988. Write-offs as accounting procedures to manage perceptions. *Journal of Accounting Research* (Supplement): 91–119.

Engardio, P. 1987. Tony Burns has Ryder's rivals eating dust. *Business Week* (April 6): 104–107.

———. 1989. Suddenly, Ryder's engine is sputtering. *Business Week* (June 19): 56.

Financial Accounting Standards Board. 1985. *Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements*. Stamford, CT: FASB.

———. 1975. *Statement of Financial Accounting Standards No. 4: Reporting Gains and Losses from Extinguishments of Debt*. Stamford, CT: FASB.

———. 1985. *Statement of Financial Accounting Standards No. 87: Employers' Accounting for Pensions*. Stamford, CT: FASB.

———. 1987. *Statement of Financial Accounting Standards No. 96: Accounting for Income Taxes*. Stamford, CT: FASB.

———. 1988. *Statement of Financial Accounting Standards No. 100: Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*. Stamford, CT: FASB.

———. 1989. *Statement of Financial Accounting Standards No. 103: Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*. Stamford, CT: FASB.

———. 1991. *Statement of Financial Accounting Standards No. 108: Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*. Stamford, CT: FASB.

———. 1992. *Statement of Financial Accounting Standards No. 109: Accounting for Income Taxes*. Stamford, CT: FASB.

Fins, A. N. 1991. How good a mechanic is Tony Burns? *Business Week* (April 8): 71.

Gujarathi, M. R., and R. E. Hoskin. 1992. Evidence of earnings management by the early adopters of SFAS 96. *Accounting Horizons* (December): 18–31.

Healy, P. M., and K. G. Palepu. 1993. The effect of firms' disclosure strategies on stock prices. *Accounting Horizons* (March): 1–11.

Hendriksen, E. S., and M. F. Van Breda. 1992. *Accounting Theory*, 5th ed. Homewood, IL: Richard D. Irwin, Inc.

Nurnberg, H. 1983. Issues in funds statement presentation. *The Accounting Review* (October): 799–812.

Ryder System, Inc. Annual Reports, 1986–1991. 1987–1992. Miami, FL: Ryder System, Inc.

Ryder System sets early redemption of nine debt issues. 1990. *The Wall Street Journal* (January 2): sec. A, p. 6.

Securities and Exchange Commission. 1993. *Staff Accounting Bulletin No. 93: Accounting and Disclosures Relating to Discontinued Operations*. Washington, D.C.: SEC.

Shohet, J., and R. Rikert, eds. 1993. *Accounting Trends & Techniques*, 47th ed. New York, NY: AICPA.

Waldman, P., and R. Christie. Ryder System, hurt by growing too fast, tries to stop skidding. 1989. *The Wall Street Journal* (July 25): sec. A, p. 1.