

How to read Conrail's 1984 Financial Results

Background

Most people can feel overwhelmed by the financial information in annual reports. Although that information is not often easy to read, it is very important because it indicates the financial health of a company. As employees and owners of 15 percent of Conrail's common stock, you may be interested in finding out just what all those numbers mean.

Before the turn of the century, few companies published financial reports . . . and few standards or guidelines existed for those who did. But as companies began to grow larger and more diversified, they began looking to a more widespread group of shareholders as sources of capital for this growth. The annual report became a way for the companies to let shareholders know how their invested capital was being used and what kind of return they were getting on their investment.

Over the years, standards were developed for fair, accurate reporting of financial results. Most annual reports contain statements from independent auditors certifying that the company has complied with these standards. A statement from Conrail's independent auditors, Coopers & Lybrand, is found on page 26 of the 1984 Annual Report.

What do the financial statements show?

The primary financial statements are:

- The **Statements of Income** (page 30) show the "bottom line" results for the year—the amount earned after subtracting costs from revenue.
- The **Balance Sheets** (page 31) show at a specific date what the company owns (assets), what it owes to others (liabilities), and what belongs to its owners (equity).
- The **Statements of Changes in Financial Position** (page 32) show for the year where cash came from—such as earnings and borrowings—and what it was used for—such as additions and improvements to track and equipment.

Also important are the **Notes to Consolidated Financial Statements** (pages 33 through 37). The Notes explain in more detail some of the most important items in the Financial Statements. For example: Note 2 shows the components of the largest asset category—Property and Equipment—including how much depreciation has accrued to those assets through use and the passage of time; Note 3 tells a reader that additional borrowings of up to \$100 million are available if needed; and Note 10 mentions known items (contingencies) which could have an impact on the Company in the future.

A guide to the Statements of Income

Revenues represent the monies Conrail earned from customers for its freight service during the year.

Operating expenses are Conrail's costs of doing business. Each category listed—Way and structures, Equipment, Transportation, and General, administrative and other—includes costs for employee compensation, rents for facilities, the cost of wear and tear on Conrail's assets (depreciation), fuel and utilities, and many other expenses.

Income from operations, calculated by subtracting operating expenses from revenues, is our profit from providing freight service.

Other income, net includes interest income from cash invested, interest expense associated with borrowings, and other income or expenses not directly related to our freight service.

Charge equivalent to federal income tax is the amount Conrail would have paid if it were required to pay federal income tax. The income tax laws allow companies to use previous losses to offset current profits so that over time income taxes are paid only on accumulated net income. The charge equivalent—\$27.8 million in 1984—is then added back into Conrail's income in the line called **Extraordinary credit resulting from utilization of net operating loss carryforward**. Even though these two categories are exactly offsetting, the accounting rules require that they be shown separately.

Net income is the "bottom line"—Conrail's net profit for the year.

Income per common share reflects the amount earned by each common share as a result of the year's performance.

A guide to the Balance Sheets

The balance sheets have two sections (**Assets and Liabilities and Shareholders' Equity**), the totals (bottom lines) of which are always equal—they "balance."

Assets

Current assets include cash and other assets that will be converted into cash within a year after the date of the balance sheet. In addition to cash and temporary cash investments, current assets include these items:

- **Accounts receivable** is what is due from customers. The "allowances" noted are the estimated amounts which might not be collected.
- **Material and supplies** shows the cost of inventory—primarily items needed for maintaining track, repairing

equipment and facilities, and fuel for powering locomotives.

Investments in and advances to affiliated companies shows Conrail's investments in companies where we own no more than 50 percent of their stock. (When a company is owned more than 50 percent, it is combined with Conrail and "consolidated" into each of the financial statements.)

Property and equipment, net represents the cost of track structure, buildings, land, signals, tunnels, bridges, locomotives, freight cars and similar assets, reduced by the accumulated depreciation in their value as a result of usage and the passage of time.

The **Other** categories of assets each include several items which do not fit into the major categories and are not large enough to be shown by themselves.

Liabilities and Stockholders' Equity

Current liabilities are all obligations expected to be paid within one year from the balance sheet date, including:

- **Accounts payable** represent the amount owed to suppliers and other creditors for materials and services already provided to the Company.
- **Wages and employee benefits** represent the amount owed for wages and benefits as of December 31. It includes the money paid to employees in their first 1985 paychecks for work performed in 1984, as well as vacation pay due to employees in 1985 for vacation time earned in 1984. Also included is the cost of restoring employee wages to industry levels effective July 1, 1984.
- **Current maturities of long-term debt** are amounts due within the next year to equipment leasing companies and others who have financed our equipment leases and acquisitions. It is comparable to the amount an individual would pay toward a home mortgage or automobile loan in a one-year period.
- **Casualty reserves** are estimates of personal injury, damaged freight and property, and other claims expected to be settled by payments during 1985.

Long-term debt, less current maturities is the amount due to parties (including the federal government) who have loaned money to Conrail, less the amounts ("current maturities") which are payable in 1985.

Casualty reserves, less current maturities represent the expected total cost to settle claims for personal injury and freight and property damages for incidents which occurred during 1984 or prior years, less the estimated portion which will be paid in 1985.

Preferred stock with mandatory redemption represents stock issued in exchange for \$2.3 billion of investments by the federal government to help finance Conrail's replacement and rehabilitation of the track and equipment acquired from the predecessor railroads. This stock is shown separately because the requirement for

mandatory redemption makes it different than a typical equity security.

Preferred stock without mandatory redemption and common stock

• **Series B preferred stock** was part of the consideration issued to the federal government in exchange for the assets of the predecessor railroads; this stock has preference over common stock with respect to dividends.

• **Common stock** includes 25 million shares issued to the federal government in connection with the creation of Conrail and 4.4 million shares held in trust for employees. If the Company is profitable, common stock has more earnings potential than preferred stock.

• **Additional paid-in capital** is the amount paid or contributed by stockholders over and above the par value of the stock.

• **Deficit** represents the excess of accumulated net losses over net income since Conrail began operations in 1976. When accumulated net income exceeds accumulated net losses, this caption is a positive component of Equity and is called Retained Earnings.

• **Stock held by subsidiary** represents Conrail common stock designated for, but not yet contributed to the Employee Stock Ownership Plan (ESOP). These 2,205,880 shares are scheduled to be contributed ratably to the ESOP over the next 5 years.

A guide to the Statements of Changes in Financial Position

The **Funds provided by operations** section shows what Conrail's operations provided in *cash* (\$739.7 million in 1984), which is different from what was provided by net income (\$500.2 million). The difference is primarily attributed to depreciation and amortization expense, which does not involve the outlay of cash.

The **Changes in working capital** portion of the **Funds provided by operations** section shows year-to-year changes in current assets and current liabilities, and how they provided or used cash.

The **Funds provided by (used for) financing activities** section shows cash generated from borrowings during the year, and cash used to pay off old debt. In 1984, these financing activities produced an increase of \$32.3 million in cash balances.

The **Funds provided by (used for) investment activities** section shows cash spent on property and equipment additions (\$555.7 million in 1984) and cash generated by selling other property.

As a result of all of the above transactions, Conrail increased cash by \$312.6 million in 1984 and had a cash balance of \$846.0 million at the end of the year. These cash balances are not idle, but rather are put in temporary investments which produce interest income to the Company until they are needed.



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