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truck times

The Financial Side of the Trucking Industry

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Katz, Sapper & Miller, LLP
Certified Public Accountants

Glider Kits Making an Impact on the Trucking Industry

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Over the past decade, the transportation industry has been transformed by the simultaneous hit of the Great Recession and the sting of stiffer EPA standards. These factors have caused several interesting byproducts, including the resurgence of glider kits.

A glider kit is essentially a new truck cab without an engine, transmission or rear axles. The old unit, referred to as a "donor vehicle," is afforded the updated look and feel of a brand new truck, although it runs on the used, former engine.

Aside from a glider kit being less than 75 percent of the cost of a new vehicle, there are additional benefits. If the cost of the glider kit does not exceed 75 percent of the cost of a comparable new truck, then there is no heavy vehicle federal excise tax charged on the transaction. The IRS has disallowed this exemption in cases that included significant new parts added to the drivetrain. Sidestepping this 12 percent tax saves carriers roughly $8,000 to $10,000 per unit.

Additionally, the more stringent EPA standards made heavy use vehicle models less fuel efficient, starting with 2007 models. However, pursuant to EPA guidelines, the converted units are not subject to the new standards (assuming the donor vehicle is a pre-2007 model). For instance, a 2003 model that is used as a donor vehicle is still considered a 2003 vehicle for EPA emission standards. As emission standards tighten on future models, this is a strategy that may be employed for several years to come.

Considering this mix of old and new parts, questions regarding proper capitalization and tax depreciation methods may occur. The IRS makes it clear under section 263, the cost of the glider and the costs associated with converting the vehicle should be capitalized. Since in most cases the glider kits are new, they would be eligible for 50 percent bonus depreciation in 2012 pursuant to Treas. Reg 1.168(k)-1(b) (note: bonus depreciation is currently set to phase out on Dec. 31, 2012).

Since these converted units, for all intents and purposes, are still used units with possibly hundreds of thousands of miles, increased maintenance costs must be added to the list of factors before considering whether or not to utilize glider kits. While glider kits have negative factors that may not be appealing to all carriers, the glider kit option has provided the transportation industry with another method of managing aging fleets and increasing costs of new equipment.

Freight Network Optimization Leads to Profitability

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Over the years, many owners have suggested that full truckload trucking (TL) is operationally an easy business – simply pick up a load at point A and deliver it to point B.

Although few would suggest that trucking is easy in today's environment, many companies unknowingly continue to operate as if TL is a simple business. Surprisingly, some carriers still believe they can accept loads from shippers to random points, find loads to their home base (usually with broker assistance) and make money.

The success of this type of operation is externally dependent upon overall supply and demand. When freight demand exceeds supplied capacity, rates provide profits; however, when the supply-demand dynamics reverse, the business falters. Many owners accept this fate as being part of the trucking business. Interestingly, however, a number of companies have developed business practices over the years that provide greater returns and more insulation from external events, such as changes in freight rates. There are carriers of all sizes and in all segments that make money in various economic environments, including the recent Great Recession and the potentially more favorable 2012.

The collection of business practices that allow certain carriers to earn superior returns relative to their competition can be referred to as the "Trucking Franchise." The Trucking Franchise is, of course, still evolving and finding new responses to ever-changing external factors, including those of the current environment.

At the heart of the Trucking Franchise is a successful freight strategy. A variety of these strategies have evolved. What appears to be more definitive than what works is what does not work, such as those original TL practices associated with a long length of haul and a "shotgun" approach to load acceptance.

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The evolving successful freight strategies are increasingly being shaped by sophisticated mathematically based freight optimization models. Freight network optimization programs are not new and have been around for more than 20 years. They were developed in response to the reality that not only is trucking exponentially more operationally complex as it increases in size, but making optimal decisions considering the numerous variables associated with equipment, drivers, geography, and customers requires mathematical modeling assistance.

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Symptoms of the Great Recession Continue to Linger

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It has often been said that trucking is the first industry into a recession and the first to emerge from a downturn. Officially, the Great Recession ended June 2009; however, the trucking industry (like many others) continues to experience hangover symptoms that are hampering robust recovery and growth. While most economists agreed that 2011 saw profit and financial improvement in the industry over 2010, this was in large part credited to reduced capacity caused by the economic upheavals that allowed rates to increase. Despite high unemployment, the industry's struggles with driver shortages will likely move to the forefront in 2012.

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Early year freight volumes are not anticipated to be anything more than fair, mainly supported by gift card shopping and retail inventory replenishment. Freight rates for 2012 are expected to increase overall due to increased freight in 2012 and an ever-tightening supply. Projected growth in auto production, housing starts and apartment units (after historical declines in these areas) means more freight even if not at the record levels considered robust. One of the many unknowns to impact freight in 2012 could likely be consumer gas prices. As fuel cost for consumers erodes disposable income, spending is likely to slow, thereby reducing freight tonnage.

Surprisingly, trucking company failures remain low. However, many companies continue to contract fleets by selling or trading two for every one new purchase.

With the cost of new equipment escalating, the availability of late-model, quality-used equipment remains limited. With unemployment figures as high as 10 percent in some cases, driver retention and turnover continue to bemoan the industry. Turnover rates were as high as 89 percent in late 2011, which is up from less than 40 percent in early 2010. Much of the driver turnover woes can be attributed to CSA standards pushing unacceptable drivers out of the workforce (not entirely a negative), extending unemployment benefits, and improving employment opportunities in industries that have traditionally competed for the same work force.

Despite these industry challenges, trucking continues to be a significant contributor to the American economy. According to American Trucking Associations (ATA) reports, the industry is a $544 billion industry with trucking representing 82 percent of the nation's freight bill. With more than 26 million trucks of all classes on the road, roughly nine billion tons of freight was hauled. Of the trucks on the road, 2.4 million are Class 8.

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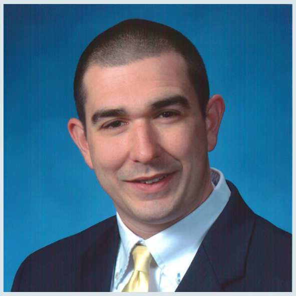
Will Income Tax Credits Impacting the Industry be Renewed?



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On Dec. 31, 2011, several income tax credits that truckers had been utilizing over the past several years expired. These credits include: the Work Opportunity Tax Credit (WOTC); the fifty-cent per gallon credit for propane used to power motor vehicles; the biodiesel fuel mixture credit; and the liquefied and compressed natural gas credit.

These credits were first introduced several years ago and had been extended annually until Dec. 31, 2011. Most commenters find it hard to imagine that the WOTC will not be extended and believe that the other credits will be extended as a part of an overall package.

A brief description of some of these credits are as follows:

Work Opportunity Tax Credit (WOTC)
The WOTC is aimed at helping those individuals that typically have a difficult time finding employment such as veterans, students and felons. In order to qualify for this credit, applicants must go through a rather simple interview process and submit paperwork to the state for approval. Some employers will use an outside service to facilitate this approval process. The credit is based on wages and caps at $2,400 per year.

Propane Credit
The propane credit is an incentive for taxpayers to use propane to power mobile equipment as an alternative to other fuel sources. Typically, mobile equipment used by truckers consists of forklifts, pallet jacks and other lifts. In order to qualify for the credit, the taxpayer must register with the IRS and obtain an "alternative fueler" identification number. Then, the taxpayer can apply for the credit two different ways by either filing form 720 on a quarterly basis or applying for it via their income tax return. This credit is calculated by multiplying 50 cents by the number of gallons consumed.

Biodiesel Credit
The biodiesel credit, much like the propane credit, is intended to reduce the demand for diesel fuel by diluting it with biodiesel. To qualify for this credit, the individual has to be a mixer of diesel fuel with biodiesel. The biodiesel credit is calculated by multiplying $1 by the number of gallons of biodiesel that has been added to the regular diesel.

Although it is unknown at this time if these credits will be renewed, trucking companies may want to take additional measures now to qualify for them with the hope that they will be rewarded later in the year.

Understanding of Loan Covenants Deemed Critical

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The current state of the economy and its effect on the credit market continues to be a significant challenge facing the transportation industry. In particular, it has become critical to carefully negotiate, understand and monitor loan covenants on a regular basis.

In the past, many owners assumed that as long as they were current on their payments, they were in good standing with their lender; however, violation of any loan covenant may give a lender reason to call the loan or increase interest rates.

As a new loan agreement is negotiated it is important to work with the bank to set realistic covenants. Growth plans should be reasonable given the current state of the transportation industry, and past performance and future budgets should be compared to the proposed covenants. It is in the best interest of the loan holder and the lender to set realistic expectations of future financial performance.

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The review of existing loan agreements to ensure a complete understanding of current covenant requirements is imperative. Typical affirmative covenants will include certain financial ratios, submission of monthly internal financials, and an annual audited or reviewed financial statement. During the last several years, more banks have been requiring audited financials than in the past. It is also common for lenders to require corporate and personal tax returns. In addition to affirmative covenants, also be aware of any negative covenants, which may prohibit additional loans, distributions, equipment purchases or changes in management or ownership without the banks' approval. If certain covenants are unrealistic, notify the lender and come prepared with a solution or other alternatives.

A process to monitor loan covenants on a regular basis should be established, which could be accomplished as part of the monthly financial reporting process. In addition to monitoring financial covenants on a monthly basis, it is also prudent to project future covenants based on the most recent forecasts and budgets. At the first sign of trouble, it is crucial to assess the situation and develop a plan. Timely, proactive communication is necessary so that the lender gains an understanding of the current situation, the proposed solution and a timeline for correcting it. Covenant waivers may also need to be requested, especially in connection with an annual review or audit of financial statements.

Whether negotiating a new loan or renewal, or operating under an existing agreement, it is crucial to understand the various loan covenants. Routine monitoring and communication with the lender will allow potential issues to be addressed in a timely manner as work begins toward a solution.

Freight Network

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Netwise®, the TMW Systems, Inc. (formerly IDSC) network optimization program, with roots going back to the early 1980s, is one of several programs that are available. The common objective of these programs is to optimize margins by finding the set of load movements that maximize revenue and minimize costs. While they differ in their algorithms, most attempt to quantify the YIELD (i.e., network-based margin per load per day) of each load movement as a function of:

- Revenue (Rate)
- Cost (Variable and Direct Costs)
- Efficiency (Time/Velocity)
- Network Balance (Flow)

These applications can be extremely useful with the following tasks, which are associated with the formulation of a successful freight network strategy:

- Identifying underperforming lanes and customers
- Understanding network imbalances and associated freight development areas
- Identifying unnecessary in-transit delays
- Identifying potential pricing adjustments on existing business
- Identifying profitable rates for new business (in context of the carrier's network)

One of the common misconceptions regarding network optimization is that the programs only work when freight is abundant (i.e., demand exceeds supply). The truth is carriers are successful when they educate themselves on the model, buy into the results and, most importantly, consistently execute the network strategies suggested by the model's results.

In today's more favorable freight environment, opportunities for freight network optimization success are even greater. That said, some carriers are hesitant (complacent) to invest in their freight strategy when prices have been increasing (and look to increase even more in 2012), while others continue to beat the market by utilizing optimization technology. Carriers should take what the market gives them – then optimize it.

Great Recession

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This represents a decrease of units from just a few years ago. Data available for 2010 by the ATA reported motor carriers spent more than $101.5 billion on diesel value compared to $79.5 billion in 2009, the lowest cost since 2004.

Before deregulation by the Motor Carrier Act of 1980, fewer than 20,000 carriers operated in the U.S. As of 2010, 378,000 for-hire trucking companies, with an additional 620,000 private fleets, were in operation. As commonly known, the industry remains highly fragmented with 97 percent of the trucking companies employing less than 20 trucks. The industry continues to be a significant employer with 6.8 million people employed in trucking-related jobs in 2009.

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Here and There in the Trucking Industry

Troy Hogan and **Jason Miller** presented an accounting and tax update at the Illinois Trucking Association's Annual Meeting in Fontana, Wis. in September 2011.

Andy Belser and **Jason Miller** attended the Indiana Motor Truck Association's Annual Convention in Washington D.C. in September 2011.

Jason Miller presented an accounting and tax update at the Future Leaders of Indiana Conference (Indiana Motor Truck Association) in Indianapolis in November 2011.

Chris Felger and **Mark Flinchum** attended the Ohio Trucking Association's Annual Convention in Cleveland in September 2011.

Tim Almack, **Mark Flinchum**, **Troy Hogan**, **Jason Miller** and **Ed Stohlman** presented the 3rd edition of Trucking Basics 101, which was held on Jan. 4, 2012, at Katz, Sapper & Miller.

Katz, Sapper & Miller held a **Trucking Owners Business Roundtable** on Feb. 7, 2012. The roundtable is part of an ongoing series co-sponsored by Katz, Sapper & Miller, **KSM Transport Advisors**, and **Scopelitis, Garvin, Light, Hanson & Feary**. The roundtable featured Thom Albrecht and Mark Davis, who discussed the 2012 economic forecast for the trucking industry.

Tim Almack has been re-elected to serve on board of directors of the Truckload Carriers Association and will also be serving on the membership committee.

***Truck Times* Editorial Committee:**

Mark Flinchum, Tim Almack, Andy Belser, Donna Blackmon, Christopher Djonlich, Jennifer Moore

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