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TRUCK TIMES

The Financial Side of the Trucking Industry

In this issue:

A Survival Plan for Truckload Carriers

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Those committed by choice or circumstance to the asset-based truckload business have had little to celebrate lately. The last 30 years have produced some very challenging times, particularly in the last two or three years.

Beyond the traditional business risks associated with trucking, today's carriers are contending with a three-year freight recession and the associated capacity/demand imbalance, the ever-increasing use of bid packages and, for all intents and purposes, the loss of shipper loyalty or "core carrier" designations.

Little near-term hope is offered, only the distant prospect of prosperity for those who survive — and survival is the order of the day for many mid-market carriers.

While good business practices always make sense, a survival mentality differs in many ways from the mindset associated with normal operating times. Survival is ultimately a function of available capital and positive cash flow.

Experience suggests that any business survival plan requires three elements:

1. Changes in management perspective
2. Access to and use of key management tools and information
3. Execution of required actions

The goal is to produce adequate cash flow for the survival period.

Changing management perspective is the first item because the major impediment to survival is generally management's failure to make a temporary change in its own mindset and in the organization's "culture."

The mindset required for survival clearly is focused on different priorities than the business-as-usual way of thinking. For example, despite their previous success, relying on past practices – and in some cases, current employees – may not produce the immediate results or magnitude of change required for survival. The hurdle is an emotional one – to terminate or replace someone who has been loyal and done his job, but who cannot help the organization going forward, is very difficult for most entrepreneurs. Unfortunately, the learning curve is steep, time is limited and second chances are very few.

Cash buys time, and time is survival. Difficult decisions frequently require choosing near-term positive cash flow at the potential expense of long-term profits. There must be an extreme organizational focus on anything that involves getting more cash, reducing the amount of cash spent or converting non-cash assets into cash.

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In addition to developing strategies for reducing expenses and enhancing revenue, management must:

- Look for ways to reduce investment in accounts receivable, driver advances and inventory while finding prudent ways to extend liability payments.
- Make fundamental changes in its mindset regarding investment criteria, activity time horizons, the definition of essential tasks and the importance of stakeholder communication initiatives.
- Establish and effectively communicate to all employees new highly directive and focused priorities.
- Shift action time horizons to days and weeks rather than months and years.
- Change earnings to cash flow.
- Eliminate or defer nonessential activities.
- Make communications with stakeholders frequent, substantive and realistic.

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Economic Incentives Also Available to Transportation Companies

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Indiana and its local communities, like other states, provide economic development incentives when companies make a commitment to create jobs and invest capital in their jurisdiction. These incentives can take many forms, including refundable and nonrefundable tax credits, reimbursable training grants, infrastructure funding, low interest loans, and other programs.

The awarding of these incentives often gets attention in the press, most notably when the business receiving the incentives is in a "targeted" industry, such as life sciences or software. This focus on targeted industries often leaves the impression that other sectors of the economy, such as transportation and logistics, may not have access to these same programs. This is not the case in Indiana or many other states.

Many states and communities have had inconsistent pasts with incentives for the transportation industry. However, the Hoosier state's recent history indicates it has looked beyond industry labels and examined each project on the basis of its unique merits, just as it would with any other type of company.

Responses to the following questions, as they relate to a transportation company's potential project, may determine a state's or local community's receptiveness to offering incentives:

- How many jobs are being added?
- Will the new employees be state residents?
- How much do the jobs pay?
- What is the amount of the capital investment?
- Does the company provide training other than CDL training?
- What is the timing of the project?
- Is the project "competitive" – in other words, is it possible that some of the job creation or capital investment could occur in another state?

If the answers to these questions fall within the state's or community's economic development goals, then the company can anticipate access to many of the same programs offered to other industries.

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Having established that transportation and logistics businesses are eligible to receive incentives, the next logical question is, "How much in incentives are we talking about?" As one might expect, this answer depends in large part on the number of jobs being created, retained, or trained; the wage levels of these jobs; the amount of capital investment; and the training budget for the company. Again, the answers to these questions will vary for every company and every project. However, with a favorable fact pattern, a transportation and logistics owner can secure and benefit from a significant level of incentives. These benefits from incentives can play a large role in enhancing the quality of the company's operations, facilities, and workforce.

Fraud Increases During Turbulent Times in Trucking Industry

By John Henne, CPA, CFE, MPA
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According to the Association of Certified Fraud Examiners President James Ratley, "The message to Corporate America is simple: Desperate people do desperate things."

There is no doubt about it, fraud is on the rise. The current economy has led to an increase in embezzlement among employees who have been with their employers for a number of years. As a result, companies are incurring losses that could potentially set them back for a significant period of time. Transportation company owners realize that a considerable fraud set back could have a devastating effect on the bottom line during a period where it has been challenging to churn a profit.

Ratley's message must be taken seriously. Any business could currently be impacted by fraud. Changes in employee behavior or lifestyles could be a signal to probe into why those changes have occurred. This is particularly telling if such changes have occurred among employees in the accounting department.

Many carriers are working with a leaner accounting department than they were in 2008 and 2007. Staff reductions, especially within accounting, are notorious for lending carriers to potential susceptibility of fraud. It is critical in these current economic times that businesses evaluate their internal control structure so that fraud can be adequately deterred. Companies should place an emphasis on the controls surrounding cash disbursements since cash is such an important part of the business.

Cash is King

Going all the way back to a college level accounting 101 course, one of the first principles emphasized is that "Cash is king." Establishing controls over the disbursements process is critical. Some companies may have eliminated an accounts payable clerk, shifting check writing and vendor set up responsibilities to the CFO or Controller. If this is the case, and no one is reviewing the CFO or Controller's work, bad news could be forthcoming.

A fraudster could potentially take advantage of this lack of segregation of duties by setting up a fictitious vendor (i.e. shell company) who may have a similar name as another vendor that is frequently used. An example of this would be if the CFO or Controller set up a fictitious company as ABC 2.

As a major fuel supplier, ABC is a recognizable entity that is typically paid on a monthly basis. A fraudster can misappropriate the funds by setting up a legal entity with a similar name, ABC 2 in this instance. A bank account is then established under the name of ABC 2, and a check is cut to the company.

"Trucking companies must establish monitoring controls to prevent cash from getting out the door."

Some schemes are significantly less involved, and as simple as the CFO or Controller writing a company check, or making an electronic funds transfer directly to himself. Trucking companies must establish monitoring controls to prevent cash from getting out the door.

Preventative Maintenance

To prevent cash from going out the door, transportation owners should review outgoing checks and related invoices over a certain threshold before checks are mailed out. Defining the threshold for review is at the discretion of the small business owner and is also dependent on the volume of transactions. Some owners may want to review all disbursements, while others set up thresholds such as every check written over a certain amount such as $5,000, $10,000, etc.

Vendor setup should be performed by someone who is not involved in the cash disbursements process (i.e. does not have check writing capabilities). Often times this may be an

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Proposed Approach to Leases Could Impact Trucking Companies' Balance Sheets

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In March 2009, the Financial Accounting Standards Board (FASB) issued a discussion paper regarding accounting for leases as part of the continued convergence projects with the International Accounting Standards Board (IASB). The paper summarizes the new proposed approach to accounting for all leases, including leases presently classified as operating leases. It also establishes some preliminary views on how to handle certain lease accounting issues and seeks comments on the preliminary views.

The existing lease accounting standards require lessees to classify their lease contracts into two buckets, operating or capital. Capital leases are defined as leases that transfer substantially all ownership rights to the lessee.

Capital leases are treated in a manner similar to the purchases of assets. The lessee recognizes on the balance sheet the liability of the lease and the underlying leased asset. The leased asset is depreciated and the lessee apportions lease payments between finance charges and a reduction of the lease liability.

Any lease that is not considered a capital lease is an operating lease, where ownership rights remain with the lessor. The lessee does not recognize the associated liability or asset, but does recognize lease payments as a period expense, normally on a straight-line basis during the term of the lease.

The primary criticism of the current standard is that it fails to meet the needs of the users of the financial statements. Particularly,

- Footnote disclosures of operating leases are not sufficient for the users to make adjustments to determine the impact on profitability as if the lease was a capital lease.
- The existence of two very different accounting models for leases means that similar lease transactions can be accounted for differently, thus reducing comparability.
- The existing standards provide opportunities to structure transactions to achieve a particular lease classification.

Arguments have also been made that the existing lease accounting framework is conceptually flawed. In particular, it fails to faithfully represent the economics of many lease contracts. Inherently, the lessee obtains a valuable right to use the leased asset (right-of-use). This right meets the FASB definition of an asset.

Similarly, the lessee assumes an obligation (the obligation to pay rentals on the leased property) that meets the definition of a liability. For example, upon entering into a 15-year non-cancellable lease of real estate, a lessee obtains a valuable right to use the property. In addition, the lessee assumes a significant obligation to make rental payments. However, if the lease is classified as an operating lease, the lessee recognizes neither an asset nor a liability (other than the accruals of rentals or prepaids).

The discussed new approach would necessitate recognition of the asset and associated liability on the balance sheet. The lessee's right-of-use asset should initially be measured at cost. Cost would be equal to the present value of the lease payments discounted using the lessee's incremental borrowing rate. Subsequently, the leased asset should be amortized over the shorter period of the lease term or economic useful life of the leased item. Discounted cash flow techniques will also be used to determine initial measurement of the obligation to pay lease payments, also using the lessee's incremental borrowing rate. The FASB believes this approach would be a reasonable approximation of fair value at the inception of the lease. Subsequent measurement would be on an amortized cost basis.

Lease contracts are frequently more complex than the simple example described earlier. Lease contracts can convey a

range of rights and obligations to the lessee. To name just a few, options such as extension of the term, early termination, purchase and escalating payments may be included in the lease contract.

The FASB considered requiring the lessee to recognize and measure each of the rights and obligations in a complex lease separately. They have preliminarily determined that this approach would be too difficult to implement. Instead, the FASB believes the lessee should measure and recognize a single right-of-use asset. Such an asset would contain the rights acquired under options and a single obligation to pay rentals that include obligations arising under contingent rental arrangements and residual value guarantees.

The discussion paper states that assets and liabilities should be recognized based on the most likely lease scenario of options that will be exercised. For instance, in a 10-year lease that includes an option to extend for an additional five years and a purchase option, the lessee must decide whether the lease term is 10 or 15 years and whether or not the option to purchase will be exercised. Measurement of the asset and liability would be consistent with the most likely lease scenario. Furthermore, reassessment would be required at each reporting date. Changes in the obligation to pay rentals arising from reassessment should be recognized as an adjustment to the carrying amount of the leased asset.

This new proposed approach may change the face of the balance sheet for many trucking companies. Multiple presentation approaches were considered by the FASB but they believe at this point in the discussion that an asset arising from a lease should be separately identified on the balance sheet from owned assets, providing users of the financial statements with more information about the leased item.

Materiality does come into play here, but based on the discussion paper, the scope, appears to be wide. While there is nothing in the discussion paper to indicate recognizing an immaterial fax machine lease, the discussion at this point does leave the door open for all lease contracts.

The FASB intends to issue an exposure draft on leases by early or mid-2010 and issue a final standard by mid-2011. No one can predict, at this point, what final result will come from this discussion paper, but it is clear that major changes may be taking place in how to account for leases in the coming years.

Fraud *(continued from page 4)*

accounts receivable clerk or a human resources employee. Nonetheless, the CFO and Controller should not be performing both check writing and vendor setup.

A small business owner should also request receipt of monthly bank statements to review the cash disbursements on the statements. It is important to scan the statements to determine if any checks or electronic funds transfers that have cleared the bank statement appear unusual. If round numbers are clearing the bank statements or unusual patterns are developing, that could signal fraud. Further investigation may be warranted.

Bank reconciliations should also be prepared or reviewed by the CFO or Controller on a monthly basis. The small business owner should review the bank reconciliation and verify that the numbers agree with what has been reported in the monthly financial statements.

Fidelity Bonding

To protect a company's assets against the risk of loss it is important to determine if the business currently has a fidelity bond to protect against embezzlement of company assets. A fidelity bond is a policy issued by many large insurance companies under which the insured entity is covered against losses caused by the dishonest or fraudulent acts of its employees. As with any other insurance agreement, fidelity policies have deductibles, a limit of liability, and certain exclusions. Given the state of the current economy, evaluating the current policy that may or may not be in place, and meeting with an insurance agent to discuss the current coverage, would be a wise move.

Final Thoughts

The recession has lent its share of difficulties for everyone in the transportation industry. Therefore, it is necessary to establish measures to minimize the risk of loss due to fraud. If there are instances where the proper control structure is in question, it may be advisable to speak with an accountant and brainstorm the changes that make the most sense.

It is not appropriate to look the other way and let the cash walk out of the business. Start by examining the processes surrounding cash disbursements and see if changes are needed. If adjustments are necessary, do not delay making the necessary changes. Remember to protect the most liquid asset, cash.

Survival *(continued from page 2)*

- Make communications with employees truthful, confident and urgent — but not panicky.

The organization itself should celebrate victories regardless of size, manage setbacks matter-of-factly and reserve collective effort for activities that materially and immediately affect cash flow.

The second survival plan element — access to and use of key management tools and information — ensures that employees have what they need to make the best decisions. This information can be obtained via forecasting models, freight network analyses and benchmarks for major cost categories.

Recommended management tools include:

- A rolling 13-week daily cash flow projection model that manages daily cash shortages and projects the ability to pay obligations
- Daily operational "key performance indicator" (KPI) flash reports to facilitate the real-time management of business operations
- Functional departmental budgets and monthly performance reviews to establish the accountability and knowledge progression required for profit improvements
- A three- to five-year, KPI-driven, financial statement projection model to support budgeting and financial statement projections
- A freight network optimization and key cost benchmarking analysis to assist with key business decisions

Finally, a successful trucking franchise is about execution. Carrier survival depends on having a specific plan and executing it better than one's peers. Beyond balance sheet management, revenue cycle enhancements and cost reductions, management should reexamine its core business model and make adjustments as needed.

It's a common mistake to assume that additional freight volume or rate increases are the answer to current revenue problems. Especially in the current environment, it's best for changes to be dictated by the quantity and quality of the existing freight network.

"Carrier survival depends on having a specific plan and executing it better than one's peers."

Accordingly, the starting point for the business model review is a comprehensive evaluation of the company's freight network to determine if some — or all — of it can produce acceptable revenue metrics. The level of acceptable revenue will direct the cost re-engineering required to produce an acceptable level of cash flow and, eventually, profits.

Address the major variable costs associated with driver wages, fuel consumption and equipment maintenance. In this economy, downsizing the fleet generally is required to address inadequate equipment utilization and needed reductions to fixed costs.

Carriers with a solid plan and strong sense of purpose find that difficult times provide not only a bridge to more prosperous periods, but an opportunity to build a true franchise capable of producing returns commensurate with the risks associated with owning an asset-based trucking company.

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Here and There in the Trucking Industry

Tim Almack attended the Truckload Carriers Association's Annual Convention and board of directors meeting in March 2009; Scopelitis, Garvin, Light, Hanson and Feary's seminar on "Issues of Law and Liability 2009 and Beyond" in May 2009; the Kentucky Motor Transport Association's Annual Convention and board of directors meeting in June 2009; and the Indiana Motor Truck Association's TIPAC Golf Outing in August 2009.

Chris Felger attended the Great West Customer ERO Leadership Symposium in Indianapolis in April 2009.

Jason Miller attended the Illinois Trucking Association's Boxing Night Event in February 2009, the Truckload Carriers Association's Annual Convention in March 2009, and the Indiana Motor Truck Association's TIPAC Golf Outing in August 2009.

Tim Almack, Bruce Jones and Jason Miller attended the Machinery Haulers Association Fall Meeting in September 2009. Bruce and Jason were the keynote speakers.

KSM's Committment to the Trucking Industry:

- American Trucking Associations
- Illinois Trucking Association
- Indiana Motor Truck Association
- Kentucky Motor Transport Association
- National Tank Truck Carriers
- Ohio Trucking Association
- Tennessee Trucking Association
- Truckload Carriers Association

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