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Proposed Update to the Audit and Accounting Guide - Airlines

Dear Ms. Mischkevich:

Ernst & Young LLP appreciates the opportunity to comment on the exposure draft to the AICPA Proposed Update to the Audit and Accounting Guide - Airlines (“Proposed Airline Guide”). We generally support the AICPA’s efforts to provide non-authoritative accounting guidance to practitioners and auditors. We do, however, have significant concerns related to the Proposed Airline Guide, particularly given that AcSEC is no longer a standard setter. While we recognize that AcSEC has attempted to communicate that in its new role it is not a standard setter and is instead restricted to providing non-authoritative interpretations of accounting literature (commonly referred to as level D GAAP), we are concerned that user confusion will continue. In addition, we are concerned that incremental GAAP from the 2003 Guide may not be properly identified without action by a standard setter, which is not expected to occur until the FASB completes its codification project. We also question the general scope of the Proposed Airline Guide in that much of the content does not address accounting or application that is unique to the airline industry. In that regard we have the following suggestions to improve the Proposed Airline Guide.

1. AcSEC No Longer a Standard Setter - While the Notice to Readers in the Proposed Airline Guide notes that AcSEC is no longer a standard setter and that changes to the 2003 Guide (as well as additions since that date) should be considered level D GAAP, we continuously encounter issues with users and industry participants where they perceive there is some formal standard setter type transition for the additions and changes. We believe that much of this confusion may be alleviated simply by changing the name of the Proposed Airline Guide so that it is clear that it is a new publication that serves a distinctly different purpose than the prior authoritative versions of the Guide. In addition, we would recommend that a discussion should be inserted clearly noting the process an entity would go through under existing GAAP to adopt changes to conform to a method (or preferable method) of accounting detailed in the Proposed Airline Guide.

2. Incremental GAAP in Prior Guide - It is often confusing to attempt to identify incremental GAAP in the 2003 Guide given the existence of conforming changes, and other updates which were never intended to be incremental GAAP. This is compounded by the fact that the 2003 Guide is viewed as the repository of incremental GAAP however, barring someone having a hard copy of that years Guide, it no longer exists. In addition, what may currently be viewed by AcSEC or the FASB staff to be the complete population of incremental GAAP in the 2003 Guide will be preliminary at best until an authoritative standard setter solicits comments and issues a standard on what has been identified. It is our understanding that this will occur as part of the FASB's codification project which is still several years away. In the meantime, we believe the comment in the notice to readers is misleading. The Notice to Readers states, "The previous edition of this guide as of May 1, 2003, may have established accounting principles that are not promulgated elsewhere. The 2003 edition of this guide is not superseded because it remains a source of level *b* GAAP. However, the reader need not refer to the 2003 edition because this edition of the guide conveniently brings forward accounting principles established by the 2003 edition." In that regard, we believe we have identified an instance (and others may be present) in which incremental GAAP was not identified in the proposed Guide (see comment 1 for further details). As a result, we believe that all 2003 accounting guidance should be identified as potentially incremental GAAP and be left unchanged pending completion of the FASB's codification project. While soliciting comments as part of the Proposed Airline Guide process may provide useful information for the FASB to consider, as AcSEC is no longer a standard setter, including or excluding portions of the 2003 Guide as incremental GAAP appears by default to be acting as a standard setter.
3. Scope of the Proposed Airline Guide – As the first industry guide issued by AcSEC post its standard setter role, the Proposed Airline Guide provides AcSEC with a unique opportunity to define what such publications will look like in the future. One of the criticisms of the current accounting environment is complexity, which in some cases is due to specific industry accounting guidance or the perception that accounting issues in a given industry are unique. Unfortunately, much of the Proposed Airline Guide deals with issues that are not unique, in either accounting or application, to the airline industry. However, by including those issues in the guide, there is a misperception that they are unique. A good example would be the discussion of pension discount rates that we have commented on later in this letter (see Other Comments section that follows). While we understand that some users would prefer a guide that touches on all major issues that affect an industry, the risk in this approach is that it cannot be done on a comprehensive basis and increases the likelihood users will rely on the Guide without properly seeking out authoritative support. The current approach also requires additional resources to be dedicated to keeping guides updated. The risk with the update process is not only that it is not done timely, but that it does not go through the formal AcSEC process, and is instead, out of necessity, updated through an abbreviated change process. Instead of this approach, we would recommend that AcSEC critically review the Guide to exclude any guidance that is not unique to the airline industry (accounting or application). In addition, to the extent AcSEC identifies issues that have broader applicability (beyond the airline industry) that should be addressed, we would suggest they be addressed through other means such as technical practice aids or issue (versus industry) specific accounting guidance.

The balance of this letter provides our responses to relevant portions of the invitation to comment as well as a few additional comments.

Revenue Breakage—Ticket Validity

Issue 1: The proposed guide defines revenue breakage as refundable and nonrefundable tickets that remain unused past departure date, have continuing validity (valid tickets), and are expected to ultimately expire unused, and valid travel vouchers that are not expected to be redeemed prior to their expiration date. The proposed guide indicates that invalid tickets are not revenue breakage and recommends that they be recognized as revenue at the point when they become invalid, which is usually the departure date.

- a. Is the definition of revenue breakage appropriate, clear, and operational? If not, how should revenue breakage be defined?*
- b. Is guidance related to invalid tickets appropriate and operational? If not, why?*

We believe that the definition of breakage contained in the guide is appropriate and clear. Further, we agree that the distinction between valid and invalid tickets is operational for those airlines that have the ability to distinguish between unused tickets that have continuing validity and unused tickets that do not. However, we understand that certain airlines may lack the information necessary to make such distinctions. For example, we understand that some airlines may not be able to accurately determine what is simply a valid unused ticket versus an unused ticket resulting from a processing error or gaming. While these limitations may exist with a portion of airlines today, this issue was very common at the time the original airline guide was issued. We suggest the guide be revised to address the situation in which an airline lacks sufficient information to distinguish between valid and invalid unused tickets and refer users to the guidance regarding the need to adjust unearned revenue on a go-forward basis. We believe that this approach is supported by both 3.41 and 3.46, of the original guide which noted “Adjustments to the unearned revenue account are made periodically for unmatched tickets, lost tickets, or tickets not processed for some other reason” and “In order to validate the ATL account under the sampling method of revenue recognition, as well as to comply with DOT requirements, each air carrier annually performs a physical verification of its passenger revenue accounting practices. The purposes of this verification are to assess the degree of reliance that can be placed on the carrier's earned passenger revenue and, at the same time, to assess the balance in the ATL account.” We believe these provisions were inserted in the original guide specifically as an acknowledgement that adjustments to unearned revenue after the fact for unmatched, lost, and unprocessed tickets is not an error but an appropriate adjustment under the accounting methodologies noted in the original guide. We also believe that AcSEC mistakenly did not include paragraph 3.46 in Appendix A as incremental GAAP.

- c. Is the point in time that a ticket has lost its value (generally the departure date) the appropriate time to recognize revenue for invalid tickets? If not, what would be the appropriate time for revenue recognition and why?*

We agree that airlines should recognize revenue for tickets that are unused and have no continuing value at the date of departure, if the information is available to identify such tickets. See prior comment.

Revenue Breakage—Timing of Revenue Recognition

Issue 2: The proposed guide describes two methods of recognizing revenue breakage for valid tickets: (1) at ticket expiration and (2) before expiration at the date when all services expected to be provided have been provided. The proposed guide states that recognizing revenue breakage for valid tickets at the date of expiration is the preferable accounting policy and that only if certain conditions are met may an airline elect to recognize breakage before expiration at the date when all services expected to be provided have been provided. If an airline meets those conditions and chooses to recognize breakage before expiration, revenue breakage may be recognized on the departure date.

a. *Is that guidance appropriate and operational? If not, why?*

We believe the guidance included in the proposed Guide relating to the timing of recognition of breakage on valid tickets is appropriate and operational.

b. *Are there other appropriate methods for recognizing revenue breakage? If so, what are they?*

We are aware that certain other industries have a practice of recognizing breakage on a so-called redemption method, over the life of the group of related items (for example, as customers use gift cards to purchase goods or services). We do not believe this is generally appropriate in the airline industry due to the nature and usage patterns of the services provided. However, we suggest the Guide be modified to specifically address the use of this method, and its acceptability in accounting for revenue breakage, for valid or invalid items.

c. *Are the conditions that have to be met for recognizing revenue breakage before expiration appropriate? If not, what changes should be made to those conditions and why?*

We believe the criteria specified in paragraph 3.86 of the proposed Guide as to the conditions that should be met are appropriate.

d. *Is the departure date the appropriate point for recognizing revenue breakage under the second method? If not, what would be the appropriate time for revenue recognition under the second method and why?*

We believe the departure date is the appropriate point for recognizing revenue breakage.

Ticket Change Fees—Timing of Recognition

Issue 3: The proposed guide describes two methods of accounting for ticket change fees: (1) as a separate and independent transaction from the original ticket sale and (2) as part of the original ticket sale. Under the first approach, change fees are viewed as a separate and independent transaction from the original ticket sale and revenue related to change fees is recognized when

the fee is assessed, which might be either when the original ticket is cancelled or exchanged. Under the second approach, it is believed that there is only one deliverable (passenger transportation) and that change fees do not represent a separate revenue-generating event. As such, revenue related to change fees is recognized when the ultimate transportation service is provided.

a. Is that guidance appropriate and operational? If not, why?

b. Are there other appropriate methods for accounting for ticket change fees? If so, what are they?

It is our understanding that discussion with the FASB Staff as part of the EITF Agenda Committee process was key in reaching the conclusion that AcSEC did. In that regard, it would seem that the discussion should be expanded to note why the request was not accepted by the EITF and how that aided AcSEC in reaching their conclusion.

Accounting for Interline FFP Miles—Effect on Valuation of FFP Liability

Issue 6: The proposed guide recommends that, when an airline that uses the incremental cost method for the valuation of FFPs enters into a contract with a new partner airline under which the airline's FFP members would be allowed to redeem their FFP miles on the partner airline, the airline accrue the additional liability based on the airline's best estimate of the portion of its FFP awards that will be settled on the new partner airline. The proposed guide provides that it would be inappropriate to not accrue a liability upon entering into a contract with a new partner due to a lack of historical experience with that particular airline. Under this guidance, an airline would be required to make an estimate upon entering into a contract with a new partner.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Effect on Valuation of FFP Liability" section of Chapter 3 of the proposed guide (paragraph 3.121).

We suggest that AcSEC reconsider the guidance contained in section 3.121 of the proposed Guide that when an airline enters into a contract with a new partner, it accrues the additional liability based on the airline's best estimate of the portion of its FFP awards that will be settled on the new partner airline. We believe that the entrance into an interline arrangement with a new partner should not result in a remeasurement of the FFP liability – particularly for those airlines that account for FFP programs using a deferred revenue method. If AcSEC decides to retain this guidance, we believe it should be expanded to discuss that factors such as the following should be considered in making the estimate of the increase in the FFP liability

- The contractual terms of the agreement with the new partner airline
- The practical limitations on the number of frequent flyers who can reasonably redeem free travel awards on the new partner airline
- The airline's expectations and forecasts developed for use in negotiating the agreement,
- The potential effect on award redemptions on other partner airlines as a result of the new agreement.

Manufacturer Purchase Incentives

Issue 7: Airlines frequently negotiate purchase and other incentives with flight equipment manufacturers whereby, as an inducement to purchase a particular manufacturer's aircraft,

engine, parts or other flight equipment, the manufacturer will grant credits or other incentives to the airline. Sometimes manufacturers provide credits for purchase that increase based upon the number of aircraft ordered and that can apply to aircraft already delivered. Consistent with guidance in Emerging Issues Task Force (EITF) Issue No. 02-16, "Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor," the proposed guide provides that subsequent changes in the estimated manufacturer purchase incentives to be achieved are changes in estimate that should be recognized using a cumulative catch-up adjustment. That is, the airline would adjust the cumulative balance of the credit recognized to the revised cumulative estimate immediately and adjust depreciation, amortization, or rent expense accordingly in the current period. Is that guidance appropriate and operational? If not, why?

While we agree with the discussion in the guide related to the accounting for incentives, we would suggest clarifying in 4.15 that training is only recognized as an asset to the extent it represents a service not yet rendered (i.e., the training has been paid for but not yet performed).

Performance Credits

Issue 8: With respect to manufacturer's credits issued to airlines for purposes other than the original acquisition of an aircraft or fleet, the proposed guide provides that the general premise is that credits issued to an airline as compensation for a short-term performance issue that is subsequently corrected are recognized as a reduction to expense, while credits issued for longer term performance issues are accounted for as a reduction in the cost basis of the aircraft because the airline has, in effect, paid less for a lower performing asset. For credits that are issued other than upon the initial acquisition of the aircraft and are accounted for as a reduction in the cost basis of the aircraft, an airline can either adjust depreciation, amortization, or rent expense solely on a prospective basis or record a cumulative catch-up adjustment to the appropriate expense caption computed as though the asset had been initially recorded at the reduced cost basis, based on the policy elected by the airline, which should be applied consistently.

a. Is that guidance appropriate and operational? If not, why?

b. Does the long-term versus short-term nature of the issue that gave rise to the credit constitute the appropriate factor to consider in determining whether to account for such credits as a reduction to expense or a reduction in the cost basis of the aircraft? If not, what would be the appropriate factor to consider and why?

We generally agree with the guidance, however in paragraph 4.21 it would be helpful to explain the reason that AcSEC believes that adjustments to the cost basis of acquired aircraft may be reflected as an adjustment to depreciation prospectively or by cumulative catch-up.

Lease Return Conditions—Swaps

Issue 12: Often an airline will choose to satisfy lease return conditions by swapping engines as part of its overall engine maintenance program. The proposed guide provides that a lease-return liability would not need to be accrued if an airline has the intent and ability to satisfy lease return conditions through swapping engines and those swaps lack commercial substance, as described in FASB Statement No. 153, Exchanges of Nonmonetary Assets. However, if it is concluded that the swaps have commercial substance, the proposed guide indicates that a lease

return liability would need to be accrued. If the airline uses either the deferral or built-in overhaul method of accounting for planned major maintenance activities, unamortized maintenance would be written off when the engine is swapped.

Is that guidance appropriate? If not, why?

Please refer to the “Return Conditions” section of Chapter 4 of the proposed guide (paragraph 4.54).

We agree with the guidance, but suggest that AcSEC clarify its views on how a standard engine swap occurring in the industry would be evaluated under SFAS 153 with respect to commercial substance. We understand the intent of this discussion is that there would generally be no accounting for return conditions satisfied through swap arrangements. However, assessing the economic substance of exchanging a fleet engine that exactly meets the minimum return conditions with the original leased engine that could have greater or less hours available is difficult at best.

Retroactive Pay Adjustments

Issue 18: Labor contracts in the airline industry are covered under collective bargaining agreements (CBAs) that are governed by the Railway Labor Act of 1926. Under the provisions of the Railway Labor Act, CBAs do not expire but rather become amendable as of a stated date. The contract negotiation process can be quite lengthy, and at times employees covered by a CBA have worked for a period of years beyond the amendable date under the existing CBA while the new CBA was being negotiated. Because of the significant delay, the new CBA may include provisions calling for retroactive wage payments to compensate employees for the period between the amendable date and the ratification date of the new contract. The proposed guide outlines a model based on FASB Statement No. 5, Accounting for Contingencies, for assessing whether it is probable that a liability for retroactive wages has been incurred and should be recorded. The model includes a description of events in the CBA negotiation process at which the probability that a liability has been incurred and the extent to which any liability is reasonably estimable should be evaluated.

Is the model provided in the proposed guide appropriate and operational? If not, why?

Please refer to the “Amendable Labor Contract” section of Chapter 5 of the proposed guide (paragraphs 5.02–19).

We believe the model provided in the proposed Guide is appropriate and operational. However, we believe the Guide should clarify that the guidance only relates to retroactive pay adjustments paid in cash. For example, if retroactive pay adjustments are in the form of share-based payments, the guidance in FASB Statement No. 123(R), Share-Based Payment, would apply and the accounting model may differ from the model provided in the proposed Guide (i.e., the accounting prior to the date when the “grant” of benefits occurs would depend on whether, based on the applicable facts and circumstances, a “service inception date” has occurred).

Airport Operating Rights

Issue 19: The proposed guide defines airport operating rights as the value of a carrier’s established operations at airports that have some or all of the following characteristics: significant barriers to entry exist at the airport, the airport is capacity constrained, or an airline has a substantial portion of the airport’s capacity. The proposed guide indicates that airport operating rights would generally meet the separability criterion specified in FASB Statement No.

141, *Business Combinations*, because the airline's underlying operations at the airport can be sold or leased in a separate transaction and therefore should be recognized as a freestanding intangible apart from goodwill. Separately identifiable slot intangible assets and certain gate lease valuation intangibles would also be recorded as separate intangibles and not as a component of airport operating rights.

- a. *Is that guidance appropriate and operational? If not, why?*
- b. *Should airport operating rights be recognized as a freestanding intangible apart from goodwill and identifiable slot intangible assets and certain gate lease valuation intangibles? If not, why?*
- c. *If airport operating rights are recognized as a freestanding intangible, what are the relevant considerations in determining the useful life of these assets?*
- d. *Would it be appropriate to consider domestic airport operating rights an indefinite-lived intangible asset? Why or why not?*

We believe that airport operating rights are generally determined to be definite-lived intangible assets due to the linkage of these rights to the terminal leases with the airport authorities. In establishing the useful lives for such assets, airlines should generally consider the lives of the terminal leases in place at the appropriate airports, which include anticipated renewals (similar to the discussion of leasehold improvements elsewhere in the Proposed Airline Guide)

Revenue Recognition for Planned Major Maintenance Activities

Issue 23: Under most capacity purchase agreements, the major airline reimburses the regional airline for planned major maintenance, and these payments may not coincide with the performance of the maintenance services. The proposed guide provides that there are two acceptable approaches to account for revenue related to planned major maintenance received under capacity purchase agreements that contain a lease under EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease": (1) regional airlines may choose to consider payments related to planned major maintenance as reimbursement of an executory cost as defined in FASB Statement No. 13, Accounting for Leases, or (2) account for maintenance-related revenue following FASB Technical Bulletin 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts. The proposed guide provides guidance about how to apply both of these methods.

Is that guidance appropriate and operational? If not, why?

Please refer to the "Revenue Recognition for Planned Major Maintenance Activities" section of Chapter 9 of the proposed guide (paragraphs 9.43–.50).

We believe that the guidance contained in section 9.43 of the proposed Guide should be clarified such that if an airline did not choose to account for payments relating to planned major maintenance activities as an executory cost as defined in FASB Statement No. 13, it can account for such payments pursuant to FASB Technical Bulletin 90-1 if such payments are within the scope of that statement. We do however, believe it is unlikely that a capacity purchase agreement will be in the scope of that statement. If such payments are not within the scope of FTB 90-1 and are not accounted for as an executory cost, we believe that the maintenance activities should be accounted for as an element included in a multiple-element arrangement pursuant to EITF Issue No. 00-21.

Other Items

Section 5.24 indicates that the selection of a discount rate for pension plans should start with rates from benchmark indices, such as Moody's Aa corporate bond index. We do not believe selecting a rate based on benchmark indices is an appropriate starting point for determining the appropriate discount rate. Instead, the starting point for determining a discount rate should be the timing and amount of a plan sponsor's expected future cash outflows for pension benefits. From there, the plan sponsor can select high quality bonds with cash flows that match the timing and amount of the future cash outflows. We believe plan sponsors should carefully consider whether the use of a rate from an index of high-quality bonds complies with the requirements of Statement 87 and 106. If using an index, the timing and amount of future cash inflows from each bond within the index should be compared against the timing of expected future cash outflows for benefit payments. Any mismatches in cash inflows and outflows should be evaluated to determine the overall effect on the discount rate. We believe plan sponsors should also confirm that each of the bonds included in the index are considered high quality and determine whether they include call or other features that affect the yield. Due to the recent credit crisis, bonds previously included in an index may no longer be considered "high quality". Additionally "make-whole" bonds (contain a floating price call feature protecting the holder from a loss) or "collateralized" bonds (collateralized by a particular asset or assets of the issuer) included in the index should be evaluated carefully to determine whether their inclusion is appropriate. The committee should consider discussing the accounting for interrelated benefit plan changes, including circumstances in which it may be appropriate to immediately recognize in income part or all of a change in a defined benefit plan obligation rather than reflecting such a change as a plan amendment that is amortized into income over future periods.

In section 5.33, we believe the discussion of the amortization of prior service cost when there is a change that increases other postretirement benefits and the change grants credit for prior service should also address the amortization period to apply when all or most of the participants receiving the benefit are inactive. If all or most participants are inactive, amortization should occur over the average remaining life expectancy of the inactive participants.

We would be pleased to meet with AcSEC or its staff to discuss our comments.

Very Truly Yours,

Ernst + Young LLP