CFRA believes that certain airline companies have recently obtained an earnings boost by extending the depreciable lives and increasing the residual values relating to operating aircraft. In addition, some airlines have recently recorded one-time write-downs and losses on the sale of aircraft, leading to questions about the proper depreciable life of aircraft.

Typically, an airline’s aircraft depreciation expense is derived by initially estimating both the useful life and the residual value -- or the perceived fair market value of the aircraft at the end of its estimated useful life. To determine the periodic depreciation expense -- which reduces the value of the aircraft on the company’s balance sheet while increasing operating expenses -- the total cost of the aircraft is reduced by the estimated residual value and that sum is divided by the estimated useful life. By increasing the estimated residual value and extending the estimated useful life of its aircraft, an airline company would prospectively record a lower depreciation expense on its income statement and a higher value for each aircraft on its balance sheet. Consequently, the airline would receive a boost to earnings in all future periods and a boost to earnings growth during the four quarters following the change, as prior financial statements are not restated. While near term earnings would be boosted by the reduced depreciation expense, future earnings may be adversely impacted from this change as the reduced depreciation expense leads to higher reported aircraft values and, if upon disposition of the aircraft the book value is in excess of the realizable value, losses will be incurred.

Prior to 1998, most major airlines’ depreciable lives for a majority of their aircraft hovered around 20 years with an estimated residual value of generally 5% of the cost of the asset. On January 1, 1998 Continental Airlines, Inc. (“CAL”) was the first of CFRA’s studied universe of 10 major airline companies to change its depreciation policy. Specifically, CAL extended the depreciable lives of certain newer generation aircraft to 30 years from 25 and increased the estimated residual values of those aircraft to 15% from 10%. Following suit were Delta Air Lines, Inc. (“DAL”) and America West Holdings Corporation (“AWA”) during 1998 and Southwest Airlines Company (“LUV”), AMR Corporation (“AMR”), and UAL Corporation (“UAL”) during 1999, while Alaska Airgroup Inc. (“ALK”), Northwest Airlines Corporation (“NWAC”), Trans World Airlines, Inc. (“TWA”), and US Airways Group, Inc. (“U”) have all apparently made no recent changes in their policies.

CFRA is especially concerned about these changes in depreciation estimates as many of the companies have recently recorded write-downs or incurred losses on the disposition of certain aircraft. These write-downs and losses indicate that prior estimates of useful lives and residual values were overly ambitious as the current recorded book value of aircraft exceeded the fair market value and thus a lower useful life and residual value might be the more appropriate change as opposed to a higher useful life and residual value.

Of the ten companies examined, CFRA believes U and ALK use the most conservative depreciation policies while CAL and TWA appear to employ the most aggressive depreciation policies. Below is a company-by-company analysis of each company’s depreciation policy ranked by those who have enacted recent changes to their policy.
Airline Companies which have Recently Changed Depreciation Policies:

Continental Air Lines, Inc. (“CAL”) – CAL increased its estimated useful life on certain new generation aircraft and increased the residual value on all aircraft on January 1, 1998. Specifically, CAL changed to an estimated useful life of 30 years from 25 years on newer model planes the Company has recently purchased. Furthermore, CAL increased its estimated residual value on all aircraft to 15% from 10%. CAL officials indicated the change was made because aircraft purchased during the 1970’s were continuing to be used and that newer aircraft were more fuel-efficient. However, in recent years, the Company has recorded two aircraft write-downs: $122 million in the September 1998 quarter and $128 million in the September 1996 period. CAL did not disclose the earnings effect of this change for the year ended December 1998.

Delta Air Lines, Inc. (“DAL”) – DAL extended the life of certain new generation aircraft types on July 1, 1998 to 25 years from 20 years. Furthermore, the Company’s residual values for aircraft changed from a policy of 5% of the cost of the aircraft to between 5% to 10% of the cost. This change reduced depreciation expense by $92 million for the fiscal year ended June 1999, resulting in a boost to reported earnings of $0.37. Absent the change CFRA estimates DAL’s fiscal 1999 earnings would have been $6.83 rather than the reported $7.20. Furthermore, we find this change particularly unusual since DAL recorded a charge of $107 million to write-down to estimated fair value aircraft parts and obsolete flight equipment and parts during the September 1999 quarter.

America West Holdings Corporation (“AWA”) - On October 1, 1998 AWA increased the average depreciable life of its 737-200 aircraft by four years while holding constant the residual value. The depreciable lives of aircraft prior to that change had been between 11 and 22 years. As a result of this change, depreciation expense was reduced by $2.0 million in each of the subsequent four quarters. Had AWA not made this change, earnings for the nine months ended September would have been reduced by $0.09 per share: to $2.17 from the reported $2.26.

Southwest Airlines Company (“LUV”) - Effective January 1, 1999 LUV extended the depreciable lives of its 737-300/500 airplanes to 23 years from 20 years. As a result of this change, depreciation expense for the three and nine months ended September 1999 was reduced by $6.4 million and $19.3 million, respectively. Absent the change in estimate, earnings for the September quarter would have been lower by $3.9 million: to $123.1 million from the reported $127.0 million. Likewise, earnings for the nine months ended September would have been reduced by $11.8 million: to $368.7 million from the reported $380.5 million.

Furthermore, the depreciable lives of all other aircraft were apparently extended as well. Specifically, the Company’s 1997 policy had been reported as a useful life of 12 to 20 years, while the 1998 policy was indicated as 20 to 25 years.

AMR Corporation (“AMR”) - AMR changed its useful life and residual values for certain aircraft on January 1, 1999. Specifically, the Company lengthened its useful life to 25 years from 20 years and increased the residual values from 5% to 10%. By making this change, AMR reduced its depreciation expense by $39.0 million and $119.0 million for the three and nine months ended September from what would have prevailed absent the change. Had the Company not made this change, earnings for the September 1999 quarter would have been cut by $0.15 per share: to $1.61 from the reported $1.76. Earnings for the nine months ended September would have likewise been reduced by $0.44: to $4.00 from the reported $4.44.
UAL Corporation (“UAL”) - On April 1, 1999 UAL increased the depreciable life of certain aircraft to 25 years from a previous standard of 20 to 23 years. Furthermore, the Company increased the residual values of those same aircraft to 10% from the previously reported 4.5% to 7.3%. As a result of this change, depreciation expense was reduced by $30.0 million during the six months ended September. Had UAL not made this change, earnings for the nine months ended September would have been reduced by $0.27 per share: to $8.92 from the reported $9.19.

Airline Companies which have not Changed Depreciation Policies:

Alaska Airgroup Inc. (“ALK”) - ALK has maintained constant its depreciation policy at eight to 20 years for aircraft, which ranks as one of the most conservative in the industry.

Northwest Airlines Corporation (“NWAC”) - NWAC has held constant its depreciation policy at a range not exceeding 25 years.

Trans World Airlines, Inc. (“TWA”) – Although TWA’s depreciation policy has remained unchanged over the past two years, the Company’s policy of a 16 to 30 year useful life is relatively high in comparison to the others in the industry.

US Airways Group, Inc. (“U”) - U’s depreciation policy, one of the industry’s most conservative, has remained constant over the past two years at a useful life of eleven to 20 years for aircraft.