ASSOCIATION OF AMERICAN RAILROADS

Finance & Administration
Jeffrey Marsh
Vice President & CFO

July 26, 2011

Elizabeth M. Murphy, Secretary
File Reference No. 4-600
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: SEC Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards:* Securities and Exchange Commission Staff Paper, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers - Exploring a Possible Method of Incorporation*

Ladies and Gentlemen,

The Association of American Railroads ("AAR") appreciates the opportunity to comment on the Staff Paper, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers - Exploring a Possible Method of Incorporation* issued on May 26, 2011.

The AAR is an incorporated, nonprofit trade association representing the nation's major freight railroads and Amtrak. AAR members range from the largest (Class 1) to smaller railroads operating in the United States ("U.S."), Canada and Mexico that prepare financial statements in accordance with accounting principles generally accepted in the U.S. ("GAAP"). In matters of significant and common interest to its members, the AAR frequently appears before Congress, the courts and administrative agencies on behalf of the railroad industry.

If the Commission were to choose to incorporate or adopt International Financial Reporting Standards ("IFRS"), we are supportive of the "Condorsement" approach. This approach will provide an orderly transition to a single set of high-quality, globally accepted accounting standards. We further believe that a phased transition plan, which is tailored at the individual standard level and is implemented over a five to seven year period, will be effective in minimizing the costs and burden of transitioning to IFRS. However, we would like to emphasize that any transition period should be clearly defined and specifically address how and when individual IFRSs will be incorporated well in advance of actual incorporation.

In addition, we recognize the active role that both the Financial Accounting Standards Board ("FASB") and the Commission play in providing financial statement users with meaningful financial information, protecting investors, and ensuring fair, orderly and efficient capital markets. We believe that both the

FASB and Commission should have an active role in the international accounting arena to assist in the development and promotion of accounting standards that address the needs of their U.S. constituents.

While maximizing the number of IFRSs subject to prospective application may lessen the cost and burden of transition, we recommend that the transition method be carefully considered for individual standards. In some cases, retrospective application may be necessary in order to maintain comparability of financial information across entities. In this context, we believe that maintaining flexibility in the manner in which an organization may adopt and apply these existing standards, while complying with IFRS, could be beneficial and would serve to promote the integrity of the requirements of those standards.

We note that the Staff used IAS 16 and, specifically, the componentization requirement to illustrate how an IFRS not subject to standard setting might be incorporated into GAAP. While the Staff Paper recognizes that it would be difficult for U.S. issuers to retrospectively apply the componentization requirements, it does not address whether or not IAS 16 and/or the componentization requirements within the standard are appropriate for U.S issuers. Many companies in capital intensive industries follow the group method of depreciation.

We are of the view that when considering componentization it is important that group accounting, which is an acceptable method for accounting for property, plant and equipment under GAAP, continue to be an acceptable method of accounting within IFRS. Therefore, we recommend that prior to implementing IAS 16 there is active deliberation related to the application of the group method of depreciation. As further evidence of the appropriateness of the group method of depreciation for homogeneous groups of assets, we have attached a paper prepared by William M. Stout of Gannett Fleming, Inc. which was presented to the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (Attachment 1).

We would be pleased to answer any questions that the Commission may have and discuss further any of the comments made in this letter on behalf of AAR members.

Sincerely,

Jeffrey Marsh
Vice President & CFO

Encl.: Gannett Fleming Paper on Group Accounting

A Comparison of Component and Group Depreciation For Large Homogeneous Groups of Network Assets

A Presentation to the Accounting Standards Executive Committee
of the American Institute of Certified Public Accountants
By William M. Stout, P.E.
President, Valuation and Rate Division
Gannett Fleming, Inc.

INTRODUCTION

Depreciation is the expense recognition of the cost of assets that provide an economic benefit over a period that is greater than a year. Depreciation represents a measure of the loss in this economic benefit or value of the asset in each year that it provides service. Under generally accepted accounting principles, depreciation accounting is "a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation."[1] Thus, rather than a determination in each year of the value that remains, the original cost less salvage is allocated to each year using a method of allocation, e.g. straight line.

The determination of depreciation expense for a single item, unit or component is a relatively straightforward process. (The terms unit and component depreciation are used interchangeably in this paper.) The cost of the item, less its estimated salvage value, is divided by its estimated service life. In the event the asset is retired prior to the estimated life, the book value remaining, after recognition of any salvage costs or recoveries, is charged as an expense in the year of retirement. If the asset remains in service beyond the estimated life, depreciation expense ceases inasmuch as the full cost of the asset has been recorded to expense.

The determination of depreciation expense for large homogeneous groups of assets such as the assets of railroads or public utilities is a more complex process. It is not possible to account for the depreciation expense of each and every asset required to provide railroad service over thousands of miles. Instead, the calculation of depreciation expense for such large groups of assets requires (1) the segregation of the assets into logical depreciable groups, e.g., ties, based on the function and nature of the assets, and (2) the use of averages: average salvage and average service life. Standard, or uniform, systems of accounts are used in many industries to classify or segregate the assets into homogeneous groups. Average values are required because not all of the assets in the groups of similar function and nature experience the same service life or realize the same

[1] Accounting Research Bulletins (ARB) No. 43, Chapter 9C, paragraph 5.

salvage value. That is, despite the fact that the assets in the group are homogeneous, they experience lives and salvage values that are dispersed over a wide range. Generalized survivor curves are used to describe the dispersion of lives over time.

SYSTEMS OF ACCOUNTS

Most, if not all, capital-intensive regulated industries classify their assets in accordance with a uniform system of accounts (USOA) promulgated by their regulator, e.g., the Surface Transportation Board, the Federal Energy Regulatory Commission, the Federal Communications Commission, and so on. These systems of accounts prescribe the capital accounts to be used and the type of assets to be included in each account. For example, in the railroad industry, there are separate accounts for grading, ties, rail, ballast, signals, communications equipment, locomotives, freight-train cars, and so on.

Most of these accounts contain thousands or millions of like items that have been installed over a long period of time. Millions of like items because of the thousands of miles of network (rail lines, electric transmission lines, gas pipelines, etc.) with the same type of assets used in mile after mile. A long time, because most of the assets used by these industries in providing service to their customers are long-lived assets.

The uniform systems of accounts also set forth definitions of depreciation and the manner in which it is to be determined. All of the systems of accounts require the use of group straight-line depreciation.

GENERALIZED SURVIVOR CURVES

The dispersion of retirements experienced by railroad and public utility property groups is described using systems of generalized survivor curves. The most commonly used are the Iowa survivor curves. These curves were developed at Iowa State University during the 1920's and 1930's using statistical analyses of actual retirements of various types of industrial property including railroad ties.

The Iowa curves consist of four families of curves. There are a total of 22 generalized curves in these four families. The families are defined by the relationship of the mode of retirement, the age at which the largest percent of property is retired, to the mean or average life of the group. Curves in which the mode of retirement occurs prior to, or graphically to the left of, average life are known as left-mode or L type survivor curves. S type or symmetrical curves are those in which the mode and mean occur at the same age. R type or right-mode curves are those in which the mode occurs after the average life. O type curves are those in which the greatest frequency of retirement occurs immediately or at the origin. The curves within each family are distinguished by the height of the mode of the frequency curve. The variation in the height of the mode results in curves that have narrow dispersion and curves that have wide dispersion of retirements.

The Iowa curves have repeatedly passed tests of their ability to describe the dispersion of assets retired within groups of industrial property.

DEPRECIATION STUDIES

The same regulators that establish the USOAs for these industries also require the preparation of periodic depreciation studies. Such studies are submitted, reviewed and approved by the regulators. The regulators issue orders pursuant to these reviews that specify the annual depreciation accrual rates to be used by the company.

Depreciation studies conducted for railroads and public utilities consist of statistical analyses of historical retirements for each group of property, reviews of the operation and condition of the property, discussions with management regarding its outlook for the assets, and comparisons with the estimates made for the same asset group by other companies. The results of the statistical analyses are similar to those obtained by an actuary analyzing the mortality of human beings. The results are interpreted and extrapolated using generalized survivor curves such as the Iowa curves. Depreciation studies are usually conducted every three to six years in order to discern any changes in probable average service lives or net salvage values. Further, calculations of the theoretical accumulated provision for depreciation are compared with the actual accumulated provision on a more regular basis to ascertain the need for an updated study prior to its normal schedule.

The results of depreciation studies indicate service lives for the individual assets within the homogeneous groups analyzed that vary widely. That is, although the assets within the group are basically the same, a tie is a tie is a tie, the period of time during which they are in service can range from 1 year to 100 years or more. The forces of retirement that act on these assets are numerous and act in varying degrees on different assets. It is not possible when a group of assets is first installed to predict which specific assets will remain in service for 10 years, which will remain in service for 20 years, etc. However, the results of depreciation studies permit a statistical forecast of the portion of the group that will live to each age and, from that forecast, the ability to determine the overall average life of the group.

COMPONENT AND GROUP DEPRECIATION FOR A SINGLE VINTAGE

As noted previously, the networks of assets used to provide rail and utility services have been installed over a period of many years and experience relatively long lives. Within each group of like assets, the property added during a single year of installation is referred to as a vintage of assets.

The application of the component or unit method of depreciation and the group method of depreciation for a single vintage or installation year will be illustrated with an example as presented in the attached table. In the example, ties with a cost of $100,000 are added during the year. The ties survive in accordance with the Iowa 25-S2 survivor curve. The 25-S2 has a 25-year average life. The S2 survivor curve is a symmetrical curve with a wide dispersion and is similar to the normal distribution. Salvage is ignored in order to simplify the example.

The cost of ties from this single vintage that survive at the beginning of each year, based on the 25-S2, is shown in column 2 of the table. The cost retired in each year is presented in column 4 and is the difference between succeeding amounts in column 2. The depreciation expense under group depreciation in column 3 is determined by applying the annual depreciation accrual rate of 4 percent to the surviving balance in column 2. The depreciation expense using the group concept is proportional to the property in service. That is, the amount of expense is proportional to the service being rendered, as represented by the property in service, and, therefore, to the benefit received.

The depreciation expense under unit or component depreciation, as shown in column 7 of the table, consists of two components. The first component is the depreciation expense based on group depreciation, column 3, and the second component is the loss on retired property, column 6. The loss on retired property is calculated by subtracting the accumulated depreciation related to the retired property, column 5, from the cost retired in column 4. The accumulated depreciation is the cost retired multiplied by the ratio of its age at retirement to its estimated life, 25 years. For example, the accumulated depreciation related to the $793 retired at age 10 is calculated by multiplying $793 by the ratio of 10 over 25 or 40 percent. Forty percent of $793 is $317, the amount shown in column 5 at age 10.

The second component, or the loss, is the presumed value of the retired asset that was not recorded to expense during its life. Under unit or component depreciation, this amount is also recorded as depreciation expense in the year of retirement. As a result, at age 25, the full cost of assets that did not live to the average life has been recorded as expense. Further, at age 25, the full cost of assets that will live beyond age 25 also has been recorded as expense. Thus, under component depreciation, there is no depreciation expense recorded for this vintage in years 26 through 50.

Both the component and group depreciation methods record the full cost of the vintage of ties to expense. The component method records all depreciation expense between the time the property is installed and the time the property attains an age equal to its average life. No depreciation expense is recorded subsequent to the average life, despite the fact that significant property continues to render service. The group method records depreciation expense throughout the life cycle of the vintage or installation year in proportion of the amount of property rendering service.

The group method better reflects a matching of the expense recorded with the benefit received from this group of ties. The bundle of services purchased with the investment of $100,000 is the dollar-years of service rendered by the group. In total, 2,500,000 dollar-years of service are purchased. The dollar-years of service are the investment of $100,000 multiplied by the average life of 25 years. The component method attributes greater service in each year to the assets that have lives that are shorter than the average life as compared to the assets that have lives that are longer than the average life. The group method attributes equal service in each year to all assets. For example, in the first full year of service, there are 100,000 dollar-years of service rendered by the group and $4,000 of depreciation expense is recorded. In year 25, there are 50,000 dollar-years of service rendered and half as much depreciation expense, $2,000, is recorded. Group depreciation results in depreciation expense that is proportional to the service rendered.

VARIATIONS FROM ESTIMATED SURVIVOR CURVE

As demonstrated above, group depreciation provides for better matching of depreciation expense with the service rendered. Over a period of time, for multiple vintages, group depreciation results in annual depreciation expense that is the same as the depreciation expense that results from component depreciation.

In reality, the cost of ties and other assets do not survive exactly in accord with the estimated survivor curve. Minor variations tend to offset over time or, if there is a trend toward longer or shorter lives, periodic depreciation studies appropriately adjust the depreciation expense going forward. In the event that there is a substantial variation from the estimated survivor curve as a result of retirements in one year, group depreciation can and does accommodate expense recognition of the loss. Such recognition of extraordinary retirements as a loss is appropriate. Recognition of the typical variability of service lives within homogeneous asset groups as a loss, as is done under component depreciation, is inappropriate.

CONCLUSION

Railroad and public utility properties consist of large numbers of assets. These assets make up long-lived networks of many thousands of miles that are constantly being renewed. These assets are classified into homogeneous groups of similar function and nature based on systems of accounts promulgated by regulators. Periodic depreciation studies are conducted of these assets in order to insure that depreciation expense reflects the services rendered by the assets. Generalized survivor curves have proven effective in describing the life characteristics of such assets.

Unit or component depreciation is appropriate for single items of property. But, railroad and utility assets do not represent single items of property. They represent very large networks of assets. Group depreciation has been used for these assets for many years consistent with requirements of regulators and generally accepted accounting principles.

For long-lived network assets, component depreciation records the full cost of a vintage as expense by the time the vintage reaches its average life, leaving no expense to be recognized for the service rendered by assets that live beyond the average life. Group depreciation, in contrast, records the full cost of a vintage in proportion to the service rendered by the assets. For multiple vintages, as is the case for the typical group, the depreciation expense in any year becomes the same under component and group depreciation.

Component depreciation recognizes losses for every retirement that occurs prior to the average life of a group. Such recognition does not represent a true economic loss when viewed from the perspective of a large group of networked assets. Retirements from large groups of homogeneous assets will always be dispersed about an average with some retired prior to the average and others surviving beyond the average. If such retirements are substantial and deviate from the estimated survivor curve, a loss can and should be recognized under group depreciation. Otherwise, periodic depreciation studies should be relied on to ensure that the amount of depreciation expense recorded in each year, based on group depreciation, reflects the service rendered by the assets.

COMPARISON OF DEPRECIATION EXPENSE USING UNIT AND GROUP METHODS FOR A SINGLE INSTALLATION YEAR ACCOUNT 8, TIES, BASED ON A 25-S2 SURVIVOR CURVE

		Group	Retirement			Total
		Depreciation		Accumulated		Unit
Age	Survivors	Expense	Cost	Depreciation	Loss	Expense
(1)	(2)	(3)=(2)x0.04	(4)=(2)(i)-(2)(i-1)	(5)=(4)x(1)/25	(6)=(4)-(5)	(7)=(3)+(6)
0	100,000	2,000	-	-	-	2,000
1	100,000	4,000	-	-	-	4,000
2	99,998	4,000	2	0	2	4,002
3	99,987	3,999	11	1	10	4,009
4	99,953	3,998	34	5	29	4,027
5	99,876	3,995	77	15	62	4,057
6	99,726	3,989	150	36	114	4,103
7	99,471	3,979	255	71	184	4,162
8	99,075	3,963	396	127	269	4,232
9	98,500	3,940	575	207	368	4,308
10	97,707	3,908	793	317	476	4,384
11	96,660	3,866	1,047	461	586	4,453
12	95,329	3,813	1,331	639	692	4,505
13	93,685	3,747	1,644	855	789	4,537
14	91,707	3,668	1,978	1,108	870	4,539
15	89,384	3,575	2,323	1,394	929	4,505
16	86,708	3,468	2,676	1,713	963	4,432
17	83,684	3,347	3,024	2,056	968	4,315
18	80,324	3,213	3,360	2,419	941	4,154
19	76,648	3,066	3,676	2,794	882	3,948
20	72,684	2,907	3,964	3,171	793	3,700
21	68,468	2,739	4,216	3,541	675	3,413
22	64,042	2,562	4,426	3,895	531	3,093
23	59,454	2,378	4,588	4,221	367	2,745
24	54,755	2,190	4,699	4,511	188	2,378
25	50,000	2,000	4,755	4,755	-	2,000
26	45,245	1,810	4,755			
27	40,546	1,622	4,699			
28	35,958	1,438	4,588			
29	31,532	1,261	4,426			
30	27,316	1,093	4,216			
31	23,352	934	3,964			
32	19,676	787	3,676			
33	16,316	653	3,360			
34	13,292	532	3,024			
35	10,617	425	2,675			
36	8,293	332	2,324			
37	6,315	253	1,978			
38	4,671	187	1,644			
39	3,340	134	1,331			
40	2,293	92	1,047			
41	1,500	60	793			
42	925	37	575			
43	529	21	396			
44	274	11	255			
45	124	5	150			
46	47	2	77			
47	13	1	34			
48	2	0	11			
49	1	0	1			
50	-	-	1			
Total		100,000	100,000	38,313	11,687	100,000