1991

Airline industry developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Airline Industry Developments—1991

Update to AICPA Industry Audit Guide *Audits of Airlines*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of airlines with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

The slump in the airline industry that began in 1990 extended well into 1991 and continues to strain the financial condition of many carriers—especially highly leveraged carriers with heavy debt and lease obligations. Thus far this year, one airline ceased operations, several have entered Chapter 11 bankruptcy proceedings, and still others have suspended debt and lease payments. In order to keep up their cash flows, some airlines have discounted fares to unusually low levels, inhibiting a recovery for almost the entire industry.

As the year began, fear of terrorism prompted by war in the Middle East and the effects of a recessionary economy at home combined to produce a marked decline in passenger traffic. Even though the war's end spurred an increase in travel—especially in the foreign market—the increase came at the price of rather heavy fare discounting. At the same time, fuel prices were at their highest levels in years and other cost pressures continued. As a result, the first quarter was the worst ever experienced by the U.S. airline industry, with virtually every passenger airline in the country recording a loss for the period. Although passenger traffic recovered somewhat later in the year, the increases were induced by further fare discounting, putting even more pressure on airline profitability.

Following a dramatic increase precipitated by the Persian Gulf crisis, fuel prices subsided steadily during the second quarter of the year to levels roughly the same as those in the first half of 1990. Most carriers expect to absorb the slight increase in average per-gallon fuel costs for the year through fuel-conservation measures as well as the use of more efficient aircraft.

Costs other than fuel also increased for most carriers. The industry's biggest cost factor—labor—continued its upward spiral as new union contracts took effect. In addition, fees for airport gate space and landing rights increased sharply. At the same time, many carriers faced sharply higher lease payments and debt-service obligations resulting from recent fleet expansions.

Regulatory and Legislative Developments

Passenger Facility Charges

In 1991, the Federal Aviation Administration (FAA) issued final rules establishing a passenger facility charge (PFC) program. The PFC program authorizes local airport authorities to impose specified per-passenger charges at commercial service airports to finance airport improvements. Among other things, the rules require that, beginning in 1992, any carrier (including non-U.S. airlines) that collects more than 50,000 passenger facility charges annually shall provide for an audit of its PFC account. The rules require auditors engaged to audit PFC accounts to issue "an opinion on the fairness and reasonableness of the carrier's procedures for collecting, holding, and disbursing PFC revenue." In addition, auditors are required to address in these opinions whether the quarterly reports required to be filed by the carriers "fairly represent the net transaction in the PFC account." The AICPA is currently reviewing both the format of the reports that auditors are required to issue and the related procedures to be performed in order to satisfy these requirements.

Stage II Aircraft

The FAA has issued a proposed rule that would require airlines to eliminate all Stage II aircraft from their passenger fleets by the end of 1999. Stage II aircraft include Boeing 727s, 737-100s and 200s, and 747-100s; McDonnell Douglas DC-9s (except 80s) and certain DC-10s; BAC-111s; Fokker 28s; and any Boeing 707s or DC- 8s that have been retrofitted to Stage II aircraft from Stage I aircraft. The airlines would be required to reduce their base-year pools (determined as of the end of 1990) of Stage II aircraft by 25 percent by the end of 1994, another 25 percent by the end of 1996, another 25 percent by the end of 1998, and the remaining 25 percent by the end of 1999. If at any time during this period 85 percent of an airline's fleet were to consist of Stage III aircraft, it would not have to adhere to the 25 percent schedule, but it would still have to dispose of all Stage II aircraft by 1999.

Auditors of airlines should consider whether accounting estimates of the remaining lives of Stage II aircraft in an airline's fleet continue to be appropriate in light of the proposed regulation. Since virtually all airlines will be affected by the ruling when it becomes final, there is likely to be a further glut of Stage II aircraft on the market, resulting in declines in the market values of such aircraft. Auditors should also consider whether previously estimated residual or salvage values used in calculating depreciation of such aircraft continue to be appropriate.

Related accounting issues are further discussed under "Accounting for Aircraft" in the "Audit and Accounting Issues" section of this audit risk alert.

Audit and Accounting Issues

Going-Concern Issues

The flagging financial condition of many airlines, especially when viewed in combination with generally sluggish economic conditions, may give rise to going-concern issues that need to be considered by auditors. Going-concern problems are discussed in detail in *Audit Risk Alert—1991.*

Bankruptcy Declarations

In recent months, several major airlines have commenced bankruptcy proceedings. Airlines that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 of the Federal Bankruptcy Code should follow the reporting guidance set forth in AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.* Airlines that file petitions under Chapter 7 of the Federal Bankruptcy Code should use a liquidation basis of accounting. Auditors reporting on financial statements of entities in liquidation should refer to the auditing interpretation of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 9508.33-.38, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting").

Accounting for Aircraft

Aircraft Depreciation. Concerns about economic obsolescence that were raised in last year's risk alert with regard to potential declines in the estimated useful lives and estimated residual values of aircraft continue to exist. The factors that precipitated these concerns are present to an even greater degree this year, particularly as they relate to Stage II aircraft. In addition, the disposal of aircraft and nonrenewal of leases by airlines in bankruptcy have adversely affected the value of used aircraft, particularly Stage II aircraft, in the resale and leasing markets.

The useful life of an aircraft and its residual value can be influenced by economic as well as physical factors. Such factors include market growth, technological developments, operating cost efficiency, and revenue-generating ability. In recent years, other factors, such as the price and availability of fuel, new airworthiness directives, new maintenance procedures, and required aircraft modifications, have also affected the useful lives of aircraft. High fuel prices tend to hasten the obsolescence of less fuel-efficient types of aircraft. Auditors should exercise judgment in evaluating the appropriateness of estimated useful lives and estimated residual values used in calculating depreciation of aircraft, keeping in mind factors that contribute to economic obsolescence, such as the strength of the secondary market, alternative uses, and the contemplated and long-term utilization currently assumed by the airline. Auditors may find the work of specialists such as valuation consultants to be useful in making such judgments.

Out-of-Service Aircraft. High fuel prices and updated airworthiness directives may cause airlines to decide that certain types of aircraft should be temporarily grounded. In such cases auditors should consider the appropriateness of the balance-sheet classification of the aircraft as well as the adequacy of the related depreciation provision. If an aircraft is temporarily grounded but continues to be part of an airline's strategic fleet, depreciation should continue; however, the estimated useful lives and estimated residual values that are used should be carefully evaluated. When an airline has decided to remove an aircraft from service and offer it for sale, the aircraft should be classified as nonoperating property.

Aircraft Modifications. Airlines frequently find it necessary to make modifications to aircraft in their fleets in order to meet airport noise-level restrictions, because of structural failures due to age, or simply in order to maintain current levels of operations. Auditors should carefully consider the appropriateness of costs of such modifications that are capitalized rather than charged to expense. Factors that should be considered in making these determinations include the effect of the modification on the usefulness of the aircraft and on its service life as well as the cost of the modification. Guidance on making these determinations is provided by SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications.*

SEC registrants may be required to include a discussion of certain information concerning aircraft modifications in the management's discussion and analysis (MD&A) section of their annual reports. Such information includes—

- Requirements to make additional aircraft modifications in order to maintain current levels of operation.
- The source of funding for such modifications.

- Potential increases in maintenance or modification requirements resulting from stricter airport noise-level restrictions, structural failures due to age, and other relevant factors.

Frequent Travel Award Programs

Since frequent travel award programs were created in 1981, methods of accounting for the programs have been the subject of considerable discussion. Currently, airlines account for frequent travel awards by the incremental cost method, under which the airline identifies an amount based on the incremental cost associated with transporting a passenger in an otherwise empty seat and establishes an accrual for the future obligation to provide free travel awards.

In a letter sent to publicly held airlines earlier this year, the SEC staff requested that the following disclosures concerning frequent travel award programs be included in SEC filings:

- The significant terms of any frequent flyer and other free travel award programs sponsored by the airline.
- The method of accounting for the programs, including the method of accounting for nontravel awards redeemed under the programs.
- If the incremental cost method is used, each material category of cost included in its measurement. In addition, a clear description of when the accrual is made and how the cost is estimated should be provided. If the liability established for provision of future services under the programs does not include a margin representing contribution to overhead and profit, that fact should be disclosed. The amount of the recorded liability or expense should be disclosed if it is material.
- The number of free travel awards outstanding at each balance-sheet date (expressed in terms of mileage, equivalent revenue value, points, trips, or any other similar measure). If the number of awards outstanding does not include partially earned awards, the effect of this exclusion should be quantified.
- The number of awards expected to be redeemed for purposes of estimating the liability recorded by the airline at each balance-sheet date. This may be expressed as a percentage of total awards outstanding. This disclosure should be accompanied by a description of the factors accounting for the difference between awards outstanding and awards expected to be redeemed, quantified to the extent practicable. The discussion should explain any material

change in the ratio of expected redemptions to total outstanding awards that has occurred or may reasonably be expected to occur.

- The number of awards actually redeemed in the periods presented.
- The amount of free travel award usage expressed as a percentage of passenger miles flown for each period presented.
- If the displacement of revenue customers is reasonably likely and may materially affect liquidity or operating results, emerging trends should be described in the MD&A section of the annual report.

These disclosures may be included in the financial statements, in the MD&A section, or in the description-of-the-business section of the airline's SEC filings. Material changes in frequent travel awards in interim periods should be disclosed in quarterly reports on Form 10-Q.

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This audit risk alert supersedes *Airline Industry Developments—1990.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1991* (No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter.* Additional copies can be obtained from the AICPA Order Department.

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