1992

Airline industry developments - 1992; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Airline Industry Developments—1992

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

Continued Operating Losses

The airline industry, which incurred record losses in 1990 and 1991, has continued to generate record losses in 1992. The year began with a number of positive factors, such as increased traffic and declining fuel prices, that promised healthier returns. The situation quickly changed in the second quarter, however, as the economy continued to flounder and traffic steadily declined. To increase traffic, airlines introduced new fare structures and reduced rates. Although these promotional programs succeeded in enticing ticket purchases, the drastic fare cuts resulted in continuing losses for most airlines. These losses may jeopardize the continued existence of weaker airlines, especially those currently operating in bankruptcy.

International fare cuts and increasing fuel prices have also caused continued operating losses in 1992. Although international flights have traditionally been a source of solid profits for the industry, recent fare cuts have eroded any profits that would have offset domestic fare losses. In addition, fuel prices have started to rise, resulting in projections of increased operating expenses for the remainder of the year.

Antitrust Claims

In June 1992, American, Delta, United, and USAir agreed to a proposal to pay $412.5 million to settle charges that alleged that the airlines used their fare-publishing service to communicate and limit price competition. Northwest and TWA have also agreed to proposed settlements on similar allegations. The proposed settlements are subject to approval by the United States District Court in Atlanta. Passengers who flew through any one of twenty-three major hub airports between January 1, 1988, and June 30, 1992, are entitled to participate in the proposed settlement, which would be paid in the form of discount certificates toward future flights.

International Developments

The three largest domestic carriers, American, United, and Delta, have significantly expanded their presence in international markets over the last two years. International flights have historically provided healthy profits for the industry, and the airlines hope to increase these profits with expanded international routes.

Regulatory and Legislative Developments

Passenger Facility Charges

The Federal Aviation Administration (FAA) issued final rules establishing a passenger facility charge (PFC) program in 1991. The PFC program authorizes local airport authorities to impose specified per-passenger charges at commercial-service airports to finance airport improvements. Beginning in 1992, the rules require carriers (including non-U.S. airlines) that collect more than 50,000 passenger facility charges to provide for an annual audit of their PFC accounts. Auditors engaged to audit PFC accounts are required to report "on the fairness and reasonableness of the carrier's procedures for collecting, holding, and disbursing PFC revenue." In addition, auditors are required to report whether the quarterly reports that must be filed by the carriers "fairly represent the net transaction in the PFC account." The AICPA has worked with the FAA and industry representatives to develop the following illustrative reports that satisfy both existing professional literature and the FAA's requirements.

Illustrative Report on PFC Schedules

<u>Independent Auditor's Report</u>

XYZ Airline Inc.:

We have audited the accompanying Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted by XYZ Airline, Inc. (the Company) for the year and each quarter during the year ended December 31, 199X (the Schedules). The Schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the Schedules based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Schedules. We believe that our audit provides a reasonable basis for our opinion.

The Schedules were prepared for the purpose of complying with the regulations issued by the Federal Aviation Administration of the U.S. Department of Transportation to implement Sections 9110 and

9111 of the Aviation Safety and Capacity Expansion Act of 1990. Those regulations define collection as the point when agents or other intermediaries remit passenger facility charges to the airlines. Accordingly, our audit did not encompass tests of the underlying documentation supporting the reports submitted by such agencies and intermediaries to the Company.

In our opinion, the Schedules referred to above present fairly, in all material respects, the passenger facility charges collected, withheld, refunded/exchanged, and remitted by XYZ Airline, Inc. for the year and each quarter during the year ended December 31, 199X, as defined in regulations issued by the Department of Transportation.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc. and the appropriate airport authorities. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]

[*Date*]

Illustrative Report on PFC Internal Controls

Two reporting options are available:

A. *Report on System of Internal Accounting Control Used in Administering Passenger Facility Charges (SAS No. 30*)*

Independent Auditor's Report

XYZ Airline, Inc.:

We have made a study and evaluation of the system of internal accounting control of XYZ Airline, Inc. (the Company) used in administering passenger facility charges collected, withheld, refunded/exchanged, and remitted for the purpose of complying with the regulations issued by the Federal Aviation Administration of the U.S. Department of Transportation to implement sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990. Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The system of internal accounting control of XYZ Airline, Inc. used in administering the processing of passenger facility charges consists

* This report format follows the guidance provided in Statement on Auditing Standards (SAS) No. 30, *Reporting on Internal Control.* On April 20, 1992, the AICPA issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure over Financial Reporting.* The Statement would supersede SAS No. 30 and would eliminate this report as an acceptable reporting alternative. A final Statement is expected to be issued in 1993.

of policies and procedures to process remittances of passenger facility charges received from agents or other intermediaries and to reasonably assure collection of the appropriate passenger facility charges collected directly from passengers by XYZ Airline, Inc. The system of internal accounting control also consists of policies and procedures to reasonably assure that such amounts collected are recorded properly in the Company's accounting records and that remittances are forwarded to the appropriate airport authority. Our study included tests of compliance with such policies and procedures during the period from January 1, 199X through December 31, 199X.

The management of XYZ Airline, Inc. is responsible for establishing and maintaining a system of internal accounting control to administer the passenger facility charges it collects. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that passenger facility charges are collected, withheld, refunded/exchanged, and remitted in accordance with the rules referred to above and are recorded properly to permit the preparation of the Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted in accordance with those rules.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

We were not engaged to perform, nor have we performed, a study and evaluation of the Company's overall system of internal accounting control, the objective of which would be to express an opinion on whether the system, taken as a whole, meets the objectives of internal accounting control. Accordingly, we do not express such an opinion.

In our opinion, the system of internal accounting control of XYZ Airline, Inc. used in administering passenger facility charges collected, withheld, refunded/exchanged, and remitted by the Company in effect during the period from January 1, 199X through December 31, 199X, taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc. and the appropriate airport authorities. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[*Signature*]

[*Date*]

B. *Report on Internal Control Structure Used In Administering PFCs (Attestation Standards)*

Independent Auditor's Report

XYZ Airline, Inc.

We have examined management's assertion included in its representation letter, dated February 15, 19XX, that XYZ Airline, Inc. maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 19XX, for the purpose of complying with the regulations issued by the Federal Aviation Administration of the Department of Transportation to implement sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors and irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that XYZ Airline, Inc. maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 19XX, is fairly stated, in all material respects, based upon criteria established by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc. and the appropriate airport authorities. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Stage II Aircraft

In September 1991, the FAA issued a final rule that requires 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 final ruling provides airlines with two alternative phased compliance schedules and allows the airlines to select which schedule to adopt. Accordingly, airlines are required to do one of the following:

1. **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
2. **Increase** their fleet percentage of **Stage III** airplanes to a minimum of 55 percent by the end of 1994, 65 percent by the end of 1996, 75 percent by the end of 1998, and 100 percent by the end of 1999

The alternative compliance schedules provide airlines with greater flexibility in complying with the FAA's requirement of phasing out all Stage II aircraft by December 31, 1999.

Auditors of airlines should continue to consider whether accounting estimates of the remaining lives of Stage II aircraft in an airline's fleet are appropriate in light of the final regulation. Since virtually all airlines are affected by the final ruling, 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 continue to consider whether previously estimated residual or salvage values used in calculating depreciation of such aircraft are appropriate.

Audit and Accounting Issues and Developments

Going-Concern Issues

Several consecutive years of record losses, and possibly another in 1992, together with significant fare discounts, increased operating costs, and uncertain economic conditions, have seriously damaged the financial condition of many airlines. Auditors of airlines should carefully consider going-concern issues that may result from these and other factors. Going-concern problems are discussed in detail in *Audit Risk Alert—1992.*

COSO Report on Internal Control. In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework*. The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management reporting on internal controls over financial reporting.

The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting to External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help in evaluating an internal control system.

The four-volume set (No. 990002CL) costs $50; the "Executive Summary" (No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department (see order information on page 13).

Accounting for Aircraft

Aircraft Depreciation. Concerns about economic obsolescence that were raised in prior years with regard to potential declines in the estimated useful lives and estimated residual values of aircraft continue to exist. 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 are often influenced by technological and 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 air-worthiness 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 air-worthiness 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. Auditors should continue to carefully consider the appropriateness of aircraft modification costs 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 in Statement of Position (SOP) 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications.*

Accounting for Engine and Airframe Overhaul Expense

The AICPA Audit and Accounting Guide *Audits of Airlines* describes four acceptable methods of accounting for engine and airframe overhaul expense:

- Direct expensing method
- Built-in overhaul method
- Deferral method
- Accrual method

The Securities and Exchange Commission (SEC) staff has indicated that it would question an airline's change in accounting method relating to these costs, especially if the airline changed from a conservative method, such as the direct expensing method, to a more liberal approach, such as the deferred method.

Reporting on Advertising Costs

On June 22, 1992, the AICPA issued an exposure draft of a proposed SOP, *Reporting on Advertising Costs.* The proposed SOP would amend paragraph 22 of SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications* and would require the following:

- Reporting the costs of all advertising as expenses in the periods in which those costs are incurred, or the first time the advertising takes place, unless the advertising is direct-response advertising that results in probable future economic benefits

- Reporting the costs of the future benefits of direct-response advertising as assets
- Amortizing the amounts reported as assets over the estimated period of the benefits

A final SOP is expected to be issued in 1993 and would be effective for financial statements for years beginning approximately one year after its issuance date.

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This Audit Risk Alert supersedes *Airline Industry Developments—1991.*

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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—1992,* which was printed in the November 1992 issue of the *CPA Letter.*

Copies of AICPA publications may be obtained by calling the AICPA Order Department at 800-862-4272. Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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