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AUDIT RISK ALERTS

Airline Industry Developments—1995/96

Complement to AICPA Industry Audit Guide *Audits of Airlines*

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 on by a senior technical committee of the AICPA.

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Airline Industry Developments — 1995/96

Industry and Economic Developments

After incurring losses totaling $13 billion over the past five years, the airline industry is expected to show a significant profit for 1995. Industry-wide cost cutting measures, higher air fares, more passenger traffic resulting from stronger than anticipated summer travel, and increases in foreign tourism due to the weak dollar, have all contributed to making 1995 a profitable year, thus far, for the airline industry. Moreover, for the first time since 1988, no major carriers are operating under bankruptcy protection. By midyear, planes had been flying at an average capacity of 72 percent while air fares had risen approximately 6 percent over 1994 levels. Airline stock prices, bolstered by expectations of continued profitability, have appreciated by approximately 52 percent so far this year.

Many airlines are attempting to solidify their positions of profitability by continuing efforts to reduce costs. Currently the focus of these efforts is travel agent commissions, which are typically the third largest expense behind labor and fuel. Led by a major carrier, most airlines are now cutting commissions by approximately 10 percent, capping them at $50 for domestic round trip tickets. As a result, analysts expect industry-wide savings of over $400 million. On the other side of the equation, the commission cap may have an adverse effect on travel agents. Some agencies may be unable to absorb a 10 percent decrease in commission revenue. Accordingly, auditors should be alert to the possibility that reduced commissions may call into question the collectibility of certain accounts receivable arising from travel agency sales.

Airlines continue to seek wage and work-rule concessions from unions representing transport workers, flight attendants, and pilots. However, industry profitability along with strong demand has strengthened the unions' resolve to resist further give-backs. In response, some airlines have established employee stock programs in lieu of salary increases, to compensate for salary reductions, or as productivity incentives. See "Stock-Based Compensation" in the "Accounting Issues and Developments" section of this Audit Risk Alert for further discussion.

One of the significant factors contributing to the moderate profitability experienced by the airline industry in 1994 was a decrease in fuel

costs over the prior year (approximately 13 percent lower than 1993). However, this year the industry faces rising fuel prices (10 percent to 15 percent over 1994 prices) in addition to the impending expiration of the gasoline tax exemption. The industry is attempting to lobby Congress to extend the deadline for the exemption from the 4.3 cents per gallon tax increase imposed by the current administration. The Budget Reconciliation Bill before the House of Representatives is expected to include a provision extending the exemption for two more years. However, if the exemption, which expired in October 1995, is not extended, industry profits could be reduced by as much as $700 million. Auditors should be alert to the impact of the tax increase on those carriers with fleets comprised of older, less fuel-efficient aircraft. Smaller, undercapitalized carriers, that are unable to ground these planes, will be forced to absorb significant cost increases unless such increases can be passed on to passengers through fare increases. As such, their ability to continue as going concerns may be called into question (see the following section "Competitive Environment" for discussion of this topic).

Competitive Environment

AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that, in planning their audits, auditors consider matters relating to the entity's business and the industry in which it operates. One such matter for airlines is the intensely competitive environment in which the industry operates. For example, major carriers constantly face the threat of deep fare discounting from low cost rivals. In response, carriers generally lower their own ticket prices to match the competition (a practice that leads to what are commonly referred to as fare wars) thus driving down air traffic revenues. These smaller carriers, some of which are expanding operations, typically maintain lower costs by employing a non-unionized work force, offering low-fare no-frills air travel, and by flying older aircraft which are generally less expensive to own or lease (however, see "Stage II Aircraft" in the "Regulatory Developments" section of this Audit Risk Alert). In contrast, many major carriers are saddled with the higher costs associated with unionized labor and the higher depreciation and interest expense generated by fleets of newer, more expensive aircraft. As a result, the larger carriers are more vulnerable to the effects of fare wars. Many airlines have responded to such competitive pressures by implementing restructuring programs (see "Restructurings" in the "Audit Issues" section of this Audit Risk Alert) to reduce costs. Additionally, some airlines are facing competition from unlikely sources. Carriers that rely heavily on

the business traveler are beginning to see that market segment shrink. As businesses cut costs and continue to implement advanced telecommunications technologies there has been a corresponding reduction in their need to incur the expense of air travel.

Despite expected industry profitability for the current year, these competitive pressures, along with higher fuel prices and costly regulatory requirements (see the following section, "Regulatory Developments"), may raise going-concern issues. Auditors should be alert to conditions and events such as those described which, when considered in the aggregate, indicate there could be substantial doubt about the airline's ability to continue as a going concern for a reasonable period of time not to exceed one year from the date of the financial statements being audited. In such circumstances, auditors should be aware of their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). SAS No. 59 provides guidance to auditors for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time not to exceed one year from the date of the financial statements being audited.

Regulatory Developments

Passenger Facility Charges

The Federal Aviation Administration (FAA) has in place a passenger facility charge (PFC) program that permits local airport authorities to impose specified per-passenger charges at commercial service airports in order to finance airport improvements. Airlines collecting PFCs under Sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990 have the responsibility for remitting such funds and, those carriers that have at least 50,000 passengers annually, are required to have annual audits of their PFCs collected, withheld, refunded/exchanged, and remitted by the carrier for the year and each quarter ended during the year. Further, implementing regulations in Part 158 of FAA regulations outlining policies and procedures for the PFC program require the airlines to obtain a report from their independent auditors on "the fairness and reasonableness of the airline's procedures for receiving, holding, and disbursing PFC revenues." These requirements are satisfied as follows:

1. An audit in accordance with generally accepted auditing standards of a schedule of PFC charges collected, withheld, re-

funded/exchanged, and remitted by the carrier for the year and each quarter ended during the year

2. An internal control structure examination attestation engagement in accordance with AICPA Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400)

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 Audit of PFC Schedules

Independent Auditor's Report

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 Section 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 report 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 Decem-

ber 31, 199X, as defined in regulations issued by the Department of Transportation.

This report is intended solely for the information of the Board of Directors and management of XYZ Airline, Inc., and the appropriate airport authorities. However, this report is a matter of public record, and its distribution is not limited.

[Signature]

[Date]

Illustrative Report on Internal Control Structure Used in Administering PFC's

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. However, this report is a matter of public record, and its distribution is not limited.

[Signature]

[Date]

Passenger Facility Charges — Internal Control Examination Guide

The FAA has expressed interest in developing a guide for use by independent accountants in conducting the internal control structure examination attestation engagement relative to the airline's procedures for receiving, holding, and disbursing PFC revenues. Practitioners should be alert for issuance of a final guide from the FAA.

Stage II Aircraft

The FAA has issued regulations that require airlines to eliminate certain aircraft from their passenger fleets by the end of 1999. These aircraft, referred to as Stage II aircraft, include Boeing 727s, 737-100s/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. The regulations provide airlines with the option to adopt one of the following compliance schedules:

1. Reduce their base-year fleet of Stage II aircraft (determined as of the end of 1990) 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 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 FAA's regulations provide that Stage II aircraft can qualify as Stage III if carriers fit those older model aircraft with so called hushkits which reduce the excess noise levels they generate. These kits could cost up to $2 million each. Auditors should consider management's assessment of the impact of Stage II regulations on the carrying and residual values of existing aircraft. For a related discussion, see "Impairment of Long-Lived Assets" in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Audit Issues

Ticketless Travel

The continuing trend toward "ticketless" travel raises an issue to be considered by auditors. Under this system, an airline passenger can book a flight over the telephone and be assigned a reservation number (in a manner similar to the way hotel reservations are made) rather than being issued a ticket. Since no ticket is issued, there is no ticket stub available to the auditor as a source of evidential matter. Accordingly, the auditor's consideration of the internal control structure relating to ticketless travel and the performance of analytical procedures on the related revenues and receivables, will take on increased importance.

Code Sharing Agreements

Airlines are increasingly becoming involved in marketing alliances known as code sharing agreements. These agreements may involve the coordination of flight schedules or sharing of seats on a common aircraft to the mutual benefit of the parties to the agreement. For example—

- A code sharing agreement between a regional and international carrier might require the coordination of their flight schedules so that the regional carrier could feed air traffic to the international carrier. The international carrier, in turn, would reciprocate by providing frequent flier miles to customers of the regional carrier.
- A carrier seeking to withdraw from an unprofitable route without losing a significant portion of that customer base, can continue to provide service to that market through a code sharing agreement with another carrier.
- A carrier may enter into a code sharing agreement to gain access to an international market from which it was excluded due to restrictive bilateral agreements between the U.S. and a particular foreign government. This can be accomplished by allocating seats on an airplane, along with the related ticket revenue, between the two carriers.

Such arrangements may give rise to a number of audit and accounting issues. In auditing the financial statements of airlines that are party to these agreements, auditors should become familiar with the provisions of code sharing agreements that may affect financial statement amounts and consider their accounting ramifications. For example,

there may be a need to consider the propriety of amounts and timing of revenue to be recognized under the agreement and whether potential liabilities and related costs, have been properly recorded.

Restructurings

To reverse the massive losses incurred over the past few years, many airlines implemented restructuring programs aimed at reducing costs. By revamping route systems and the frequency of flights, redeploying aircraft, obtaining labor concessions, grounding inefficient aircraft, or downsizing overall operations, many airlines have made significant progress in attaining profitability in 1995. Some carriers are likely to continue restructuring efforts in part due to the competitive pressures driving revenues down and regulatory requirements pushing costs up. When airlines restructure, auditors' should consider the impact of reductions in personnel on operations and on the internal control structure; the appropriateness and completeness of recorded liabilities relating to current restructuring plans; the carrying value of aircraft and intangibles (such as route acquisition costs); and the appropriate period for reporting the costs associated with restructurings.

In considering restructuring liabilities and costs, auditors should be aware of Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, for authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on the types of costs that should be accrued and the timing of recognition of restructuring charges. It also prescribes disclosures that should be included in the financial statements.

Internal Control Structure Implications. If, after obtaining an understanding of an airline's internal control structure, the auditor concludes that the effects of restructuring have had a detrimental impact on the ability of the structure to function, an increased level of control risk may be assessed. Auditors should, therefore, adjust the scope of their audits accordingly. Documentation of the understanding of the airline's internal control structure is required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). If that understanding reveals that the internal control structure is weak, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and a reportable condition, as defined in SAS No. 60, *Communication of Internal Control Structure Re-*

lated Matters Noted in an Audit (AICPA, *Professional Standards*, vol. 1, AU sec. 325), may exist.

Publicly Held Airlines. Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, requires that restructuring charges be reported as a component of income from continuing operations.

Environmental Issues

Environmental remediation liability laws, written at all levels of government, have exposed airlines to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act, Superfund, along with various clean air and water acts, may be used to hold airlines liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. An airline carrier's use, storage, and disposal of significant amounts of fossil fuels may raise issues relating to environmental contamination and, therefore, the possibility of enforced remediation.

The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text*, vol. 1, sec. C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10). In addition, guidance is included in the consensuses reached by the EITF in Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*, Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*, and Issue No. 93-5, *Accounting for Environmental Liabilities*.

Auditors of publicly held airlines should be aware of the SEC's SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*. The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities.
- Recognition of liabilities for costs apportioned to other potential responsible parties.

- Uncertainties in the estimation of the extent of environmental liabilities.
- The appropriate discount rate for environmental liabilities, if discounting is appropriate.
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements.

Audit Risk Alert—1995/96 contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Accounting Issues and Developments

Stock-Based Compensation

As part of continuing cost cutting measures, some airlines have attempted to reduce payroll costs or increase productivity through the issuance of stock to employees in lieu of cash.

In October 1995, the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation.* The Statement encourages companies to adopt a new fair value based method of accounting for employee stock compensation plans. However, it also allows companies to continue to measure compensation cost for such plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (FASB, *Current Text,* vol. 1, sec. C47).

The Statement also requires certain disclosures about stock-based employee compensation arrangements regardless of the method used to account for them. Companies that do not adopt the new fair value based method of accounting are required to make pro forma disclosures of net income and, if presented, earnings per share, determined as if the company had applied the new method.

The accounting requirements of FASB Statement No. 123 are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance of the Statement. The disclosure requirements of the Statement are effective for financial statements for fiscal years beginning after December 15, 1995, or for an earlier fiscal year for which the Statement is initially adopted for recognizing compensation cost. Pro forma disclosures required for entities that elect to continue to measure compensation cost using APB Opin-

ion No. 25 must include the effects of all awards granted in fiscal years that begin after December 15, 1994. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994, need not be included in financial statements for that fiscal year but should be presented subsequently whenever financial statements for that year are presented for comparative purposes with financial statements for a later fiscal year.

Auditors of airlines that issue options and warrants to their employees should consider carefully whether the accounting principles for stock-based compensation plans have been properly applied and whether financial statement disclosures are adequate.

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08). FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, sec. I13). Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

Aircraft carrying values, and their revenue-generating ability, may be affected by economic, regulatory, and physical factors. Such factors might include the price of fuel, air-worthiness directives, required aircraft modifications, and costly maintenance procedures. For example, the increase in fuel prices this year, along with the possible expiration of the gasoline tax exemption, may hasten the obsolescence of less fuel-efficient aircraft. High fuel prices and updated air-worthiness directives may cause airlines to decide that certain types of aircraft should be temporarily grounded. Additionally, regulatory requirements such as the elimination of Stage II aircraft in an airline's fleet may negatively affect the carrying and residual values of flight equipment. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 may need to be applied.

In considering an airline's implementation of FASB Statement No. 121, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342).

Risks and Uncertainties

In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term.

Examples of similar estimates that may be included in the financial statements of airlines include, but are not limited to:

- Useful lives and residual values of flight equipment
- Amortization period of route acquisition costs
- Allowance for obsolescence of expendable parts inventory
- Estimates of liabilities for frequent flier programs

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of airlines in accordance with paragraph 21 of the SOP include the following:

- Routes of regional carriers limited to a particular geographical area
- Revenue derived from flights along a particular route
- Unionized labor subject to collective bargaining agreements
- Flights along international routes

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

Auditors should be alert to the requirements of the new SOP and its impact upon the financial statements of the entity being audited. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities*, which may be relevant to airlines. The proposed SOP provides that:

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.

- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

Comments on the exposure draft were due by October 31, 1995.

Frequent Travel Award Programs

Since frequent travel award programs were created in the early 1980s, 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 in 1991, 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 Management's Discussion and Analysis (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.

SEC Accounting Guidance

The SEC has indicated in various public speeches and in letters of comment to registrants during the year that publicly held airlines that are experiencing, or are reasonably likely to experience, liquidity constraints should carefully analyze the adequacy of their MD&A disclosures regarding liquidity. Item 303 of Regulation S-K requires that

publicly held companies identify in MD&A any known trends, demands, commitments, events, or uncertainties that will result in, or that are reasonably likely to result in the company's liquidity increasing or decreasing in any material way. Further, if a material deficiency is identified, such companies should indicate the course of action that they have taken or plan to take to remedy the deficiency. Auditors should consider the consistency of the MD&A discussion of liquidity and financial condition with the company's financial statement disclosures and the auditor's report on the company's financial statements.

In regard to the required MD&A discussion of liquidity, in 1994 the SEC issued an Accounting and Auditing Enforcement Release (No. 562) relative to the alleged MD&A deficiencies of an airline. According to the release, the MD&A in certain of the airline's periodic reports failed to describe uncertainties surrounding the company's efforts to obtain additional financing and its ability to meet its existing capital commitments that were conditioned on such financing. In addition, the release states that the MD&A failed to objectively evaluate how the known uncertainties could impact the financial viability of the airline.

In considering MD&A, auditors should be aware of their responsibilities pursuant to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550). The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in the auditor's report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document, such as that presented in MD&A. However, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. Auditors should refer to SAS No. 8 for further specific guidance.

AICPA Audit and Accounting Literature

Industry Audit Guide

The AICPA Industry Audit Guide *Audits of Airlines* is available through the AICPA loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually.

Information Sources

Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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This Audit Risk Alert supersedes *Airline Industry Developments—1992.*

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Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96,* which may be obtained by calling the AICPA Order Department at the number below and asking for product no. 022180 (audit) or 060669 (compilation and review).

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext.3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Federal Aviation Administration	800 Independence Ave., SW Washington, DC	*General Information* (202) 366-4000		
National Business Aircraft Association	1200 18th Street, NW Suite 400 Washington, DC 20036	*General Information* (202) 783-9000		
National Air Transportation Association	4226 King Street Alexandria, VA 22302	*General Information* (800) 808-NATA		

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