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Accounting for developmental and preoperating costs, purchases, and exchanges of take-off and landing slots, and airframe modifications : September 30, 1988 amendment to AICPA industry audit guide, Audits of airlines; Statement of position 88-1;

American Institute of Certified Public Accountants. Accounting Standards Division

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**Statement of
Position**

88-1

**Accounting for Developmental
and Preoperating Costs,
Purchases and Exchanges of
Take-off and Landing Slots,
and Airframe Modifications**

September 30, 1988

**Amendment to
AICPA Industry Audit Guide
*Audits of Airlines***

**Issued by
Accounting Standards Division**

**American Institute of
Certified Public Accountants**

AICPA

NOTE

This statement of position amends chapter 3 of the AICPA Industry Audit Guide, *Audits of Airlines*.

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Conduct. However, paragraph 7 of Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Standard Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, and SAS No. 52, *Omnibus Statement on Auditing Standards—1987*, includes AICPA statements of position among the sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203. If an established accounting principle from one or more of these sources is relevant to the circumstances, the AICPA member should be prepared to justify a conclusion that another treatment is generally accepted.

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SUMMARY

This statement of position (SOP) provides guidance on applying generally accepted accounting principles in accounting for developmental and preoperating costs, purchases and exchanges of take-off and landing slots, and airframe modifications. Briefly, the SOP recommends the following:

- Developmental costs related to preparation of operations of new routes should not be capitalized as previously permitted under *Audits of Airlines*, the AICPA Industry Audit Guide. However, preoperating costs related to integration of new types of aircraft would continue to be eligible to be capitalized, as permitted by the guide. The amortization period for such deferred preoperating costs should begin when the new aircraft is ready to be placed in service.
- The costs of acquiring take-off and landing slots are identifiable intangible assets that should be accounted for in conformity with Accounting Principles Board Opinion No. 17, *Intangible Assets*. When airlines exchange slots, the slots acquired should be recorded in conformity with APB Opinion 17 and APB Opinion 29, *Accounting for Nonmonetary Transactions*.
- The costs associated with airframe modifications that enhance the usefulness of the aircraft should be capitalized and depreciated over the estimated useful life of the aircraft or the modifications, whichever is less. The cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period.

The provisions of this statement are effective for transactions initiated after September 30, 1988, with earlier application encouraged.

Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications

Industry Developments

Deregulation

1. In 1981, when the AICPA Industry Audit Guide, *Audits of Airlines*, was issued, airlines were regulated by the Civil Aeronautics Board (CAB). However, the Airline Deregulation Act of 1978 (ADA) terminated the CAB's authority over rates and route access on January 1, 1983, and its responsibility for evaluating the fitness of new entrants on January 1, 1985.

2. In addition to liberalizing the general provisions for awarding certificates to new airlines, the ADA established new provisions for automatic market entry and issuance of experimental certificates on a temporary basis. Other provisions eased restrictions on suspension and reduction of service and expedited market entry and exit. As a result, the ADA has enabled many new entrants to gain access to domestic markets and has allowed trunk, local service, and commuter carriers to expand and otherwise alter their service patterns. Airlines are now classified as certificated scheduled (route) airlines, certificated nonscheduled (charter) airlines, air-cargo airlines, and intrastate airlines. Within the route airline classification, airlines are now identified as major, national, regional, and air-taxi operators.

3. In addition, the ADA transferred responsibility for overseeing airline operations to the Department of Transportation (DOT). The DOT has assumed responsibility for both monitoring the air safety and fitness characteristics of the various airlines and approving merger proposals and sales of airline routes. In this new competitive environment, marketing strategies, pricing of tickets, and costs of service have become important business issues for the airlines.

International Air Transportation

4. Airline operations between countries continue to be governed by specific bilateral agreements between the countries.

The access of U.S. airlines to routes between the United States and other countries requires the approval of the respective countries for both landing rights at specified airports and frequency of flights.

5. The International Air Transport Association (IATA), a voluntary organization of international airlines, was established in 1946 to negotiate international air fares, cargo rates, conditions of service, and ancillary matters. The Federal Aviation Act required U.S. airlines participating in such an organization to obtain approval from the CAB. In 1946, the CAB granted U.S. airlines immunity from antitrust laws, permitting them to participate in IATA conferences for the purpose of establishing fares and rates. Agreements reached by the airlines at those meetings are subject to the approval of the respective governments.

6. In anticipation of deregulation in the United States, IATA established two types of airline participation: one deals with facilitation matters and is mandatory for all members; the other sets fares and rates for air transportation. Participation in the latter is optional, but a member choosing to participate in fare and rate conferences must do so for all areas served.

Air Transport Association of America (ATA)

7. Founded in 1936, the Air Transport Association of America is a trade and service organization representing member U.S.-scheduled airlines. The joint interests of the airlines as an industry are expressed through a system of councils and related committees on which airline and ATA representatives work together.

8. Because travel agent sales constitute a significant portion of the airline business, the ATA designed the Area Settlement Plan (ASP), which is operated by the Airlines Reporting Corporation. The plan enables each travel agent to submit one sales report to an area processing center that then distributes the agent's sales and receivable transactions to the respective airlines. Because the dollar volumes involved and competitive needs for sales information are substantial, the ASP program requires continuous monitoring and updating. This service is provided to the airlines and travel agents by the ATA.

9. Other plans, called bank settlement plans (BSPs), have been established recently in Japan, the United Kingdom, the Federal Republic of Germany, and other countries. The BSPs, although not identical to the ASP, contain many of the same features.

Regional Airline Association

10. The Regional Airline Association, formerly the Commuter Airline Association, is the national association of member airlines engaged in scheduled air transportation of passengers and cargo in local, feeder, and short-haul markets throughout the United States and its territories. In addition, the association's finance and accounting committee has developed a uniform system of accounts for regional airline use.

Regulations and Reporting

11. Although the CAB is no longer in existence, airline accounting information continues to be reported to the DOT in conformity with the Uniform System of Accounts and Reports (USAR) previously issued by the CAB. The USAR consists of a list of titles and account numbers and instructions for their use. DOT—and, previously, CAB—policy has been to conform its accounting requirements to generally accepted accounting principles.

12. Financial data and reports based on the USAR must be filed with the DOT on Form 41 quarterly and annually. Securities and Exchange Commission filings and annual financial reports frequently follow the wording and captions of the USAR accounts.

Computerized Reservation Systems (CRSs)

13. Computerized reservation systems (CRSs) developed by several airlines (CRS vendors) have significantly affected the industry. The systems are marketed to travel agents as an efficient method of accessing airline schedules and information regarding hotels, car rentals, and so forth. The CRSs permit the agency user to, among other things, check seat availability, make reservations, and print tickets for flights on participating domestic and international airlines. In 1984, the CAB ordered the elimination of display preference in the systems for all participating airlines (those paying a fee to participate) and required CRS vendors to charge uniform booking fees for airline users of CRSs, based on the level of service received. Nonparticipating airline schedules are also included in the CRSs for informational purposes.

14. The CRS vendors receive booking fees per segment from participating airlines on which flights are booked and user fees from the travel agencies. Some airlines have contracted with CRS vendors

to process all of their reservations through the CRS vendors' reservation systems, thereby eliminating the need for the airlines' in-house reservation systems.

15. The CRSs increase the amount of information that may be captured online at the time the reservation is booked. This information normally includes passenger name, ticket number, the travel agent selling the ticket, itinerary, class of service, and price.

Marketing Arrangements

16. One of the developments in the deregulated environment is the *hub and spoke strategy* that has been adopted by many airlines. Under this concept, the airline identifies certain cities as hub cities to serve both long-haul flights and connecting short-haul flights. This strategy has led carriers operating from a hub city to enter into agreements with other carriers to coordinate flight schedules at the hub city to facilitate the interchange of passengers. The advantage to both airlines is that each feeds passengers to the other. The agreements may include joint promotion and advertising efforts, use of the major carrier's reservation system, and dual designation of flights in a CRS or other reservation systems and the official airline guide. The dual designation of flights (that is, a national or regional flight arriving at or departing the hub city using the same flight number as the major carrier) is the subject of controversy within the industry.

Commissions

17. Before deregulation, commissions to travel agents were limited to amounts authorized by the CAB or foreign governments. Since deregulation, a myriad of commission arrangements has evolved both domestically and internationally. In addition to basic commissions, travel agents may be entitled to incentive commissions for certain routes, travel periods, and defined volumes. The independent accountant should consider the increasingly significant cost of travel agents' commissions when designing compliance and substantive tests of commissions expense.

Accounting Issues

18. The guidance presented in this statement modifies certain aspects of the guide and addresses issues that have developed as a result of deregulation.

Developmental and Preoperating Costs

19. Developmental and preoperating costs are defined on page 59 of the guide as follows:

Developmental costs include those types of costs directly related to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and expenses of regulatory proceedings.

Preoperating costs include flight crew training, maintenance training, prervenue flight expenses, insurance, and depreciation. Like developmental costs, preoperating costs relate directly to specific preoperating projects, such as preparation for operation of new routes . . . or integration of new types of aircraft . . .

20. Before deregulation, costs meeting the foregoing criteria for developmental and preoperating costs were normally deferred and amortized over the expected period of benefit, generally two-to-five years. In that regulated environment, the expected future benefit and recoverability of such costs was generally not in doubt.

21. Under the ADA, new domestic routes can be obtained more readily without regulatory delay, and there is presently little domestic protection against new entrants. The designation of additional U.S. cities as gateway cities with direct service to various international cities, as well as the increased competition over traditional international routes, has altered the historical competitive relationship and earnings potential that previously existed on given routes. Therefore, the future benefits to be derived from new routes may be uncertain in the present operating environment.

Division's Conclusions

22. Because of the current deregulated environment and the uncertainty regarding the recoverability of route developmental costs, the majority of the Accounting Standards Executive Committee (AcSEC) believes that developmental costs related to preparation of operations of new routes should not be capitalized, as previously permitted under the guide. Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business.

23. Preoperating costs related to the integration of new types of aircraft would continue to be eligible to be capitalized, as permitted in the guide.

24. A minority of AcSEC believes that the current accounting model permits the capitalization of developmental costs. They believe that the airline industry should not be precluded from capitalizing those costs.

25. After the decision has been made to defer certain preoperating costs, questions arise about the appropriate cost-accumulation periods (in other words, the end-of-the-deferral period) and the date on which amortization of deferred costs should begin. Generally, current practice is to terminate the cost-deferral period and, consequently, begin the cost-amortization period on the date scheduled air service commences. AcSEC believes that it is inappropriate to defer preoperating costs after the new aircraft type is ready to be placed in service and that the amortization period for such costs should begin when the new aircraft is ready to be placed in service.

Take-off and Landing Slots

26. New entrants to a market and airlines expanding in markets need gates, and take-off and landing slots available to them at the airports in those markets. At certain airports, the frequency of take-offs and landings at all times is generally at capacity. At other airports, the slots during popular travel times are at capacity.

27. Because an airline cannot enter a market where no slots are available, the DOT has adopted a rule under which airlines may sell or trade slots. These transactions frequently include the sale of or access to gates for the acquiring airlines. Although slots, particularly those in high-demand time periods, have always had intrinsic value, the DOT policy of transferability through sale or exchange has made the slot a salable right.

Division's Conclusions

28. When airlines buy slots, the recorded asset is an identifiable intangible asset that should be accounted for in conformity with Accounting Principles Board Opinion No. 17, *Intangible Assets*. When establishing a policy for amortization of the cost of such intangible assets, the following factors should be considered:

- The accelerated pace of change in the airline industry and the effects of competition among airports

- The uncertainty of the continuation of the current governmental policy regarding sale of and access to landing slots
- The terms of existing facility leases at airports
- Probability of new airport construction to serve the same metropolitan area
- Traffic patterns and trends and local operating restrictions

29. When an airline exchanges slots with another airline, the slots acquired in the exchange are nonmonetary assets that should be recorded in conformity with APB Opinion 29, *Accounting for Nonmonetary Transactions*, and amortized in accordance with APB Opinion 17.

Airframe Modifications

30. Historically, airlines have undertaken major programs to modify interior configurations of certain aircraft types—including the reconfiguration and replacement of seats, galley equipment, and storage space—in response to market forces and passenger demands. Since deregulation, such changes have been more frequent.

Division's Conclusions

31. If the modifications enhance the usefulness of the aircraft, the costs associated with the changes should be capitalized and depreciated over the estimated useful life of the aircraft or the modifications, whichever is less. The cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period. However, detailed records may often be inadequate to permit identification of the cost of the replaced asset; therefore, estimates may be required.

Effective Date

32. The conclusions in this statement of position should be applied to transactions initiated after September 30, 1988, although earlier application is encouraged. Restatement of previously issued financial statements is not permitted.

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