AUDIT & ACCOUNTING GUIDE

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Preface

About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been developed by the AICPA Airline Guide Task Force to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (U.S. GAAP) and to assist practitioners in performing and reporting on their audit engagements.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming changes made to the financial accounting and reporting guidance contained in this guide are approved by the FinREC Chair (or his or her designee). Updates made to the financial accounting and reporting guidance in this guide exceeding that of conforming changes are approved by the affirmative vote of at least two-thirds of the members of FinREC.

This guide does the following:

- Identifies certain requirements set forth in Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC).
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category (*b*) of the hierarchy of GAAP for state and local governmental entities, and has been cleared by the Governmental Accounting Standards Board (GASB). AICPA members should be prepared to justify departures from GAAP as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the Statements on Auditing Standards (SAS).

Attestation guidance included in an AICPA Audit and Accounting Guide is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found the attestation guidance in this guide to be consistent with existing SSAEs.

A practitioner should be aware of and consider interpretive publications applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in an applicable AICPA Audit and Accounting Guide, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by such guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to attestation. Conforming changes made to the attestation guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the attestation guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the SSAEs.

Recognition

2013 Guide Edition
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The AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Michael Carreon, Dave W. Dickson, Craig J. Isakson, and Bert Nappier.

Guidance Considered in This Guide

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued, and other revisions as deemed appropriate. Authoritative guidance issued through March 1, 2013, has been considered in the development of this edition of the guide. Authoritative guidance discussed in the text of the guide.

Authoritative guidance that is issued and effective for entities with fiscal years ending on or before March 1, 2013, is incorporated directly in the text of this guide. The presentation of authoritative guidance issued but not yet effective as of March 1, 2013, for entities with fiscal years ending after that same date is being presented differently than in past editions of this guide. This information is being presented as a guidance update, which is a shaded area that contains information on the new guidance, where appropriate. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader's purposes.

This guide includes relevant guidance issued up to and including the following:

- FASB Accounting Standards Update No. 2013-03, *Balance Sheet (Topic 210); Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*
- SAS No. 127, *Omnibus Statement on Auditing Standards—2013* (AICPA, *Professional Standards*)
- Interpretation No. 1, "Dating the Auditor's Report on Supplementary Information," of AU section 551, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 9551 par. .01–.04)
- Statement of Position 12-1, *Reporting Pursuant to the Global Investment Performance Standards* (AICPA, *Technical Practice Aids*, AUD sec. 14,450)

- SSAE No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23)
- Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With and Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07)
- Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to Other PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

Users of this guide should consider guidance issued subsequent to those listed previously to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the schedule of changes appendix. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Defining Professional Responsibilities in AICPA Professional Standards

AICPA professional standards applicable to audit engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors:

- *Unconditional requirements.* The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. GAAS use the word *must* to indicate an unconditional requirement.
- *Presumptively mandatory requirements*. The auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances. GAAS use the word *should* to indicate a presumptively mandatory requirement.

In rare circumstances, the auditor may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the auditor should perform alternative audit procedures to achieve the intent of that requirement. The need for the auditor to depart from a relevant presumptively mandatory requirement is expected to arise only when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.

Prior to SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), the phrase *is required to* or *requires* was used to express an unconditional requirement in GAAS (equivalent to *must*). With the issuance of SAS No. 122, the phrases *is required to* and *requires* do not convey a requirement or the degree of responsibility it imposes on auditors. Instead those terms are used to express that a requirement exists. The terms are typically used in the clarified auditing standards to indicate that a requirement exists elsewhere in GAAS.

AICPA professional standards applicable to attest engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on an auditor:

- *Unconditional requirements*. The auditor is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the requirement applies. The terms *must* and *is required* is used to indicate an unconditional requirement.
- *Presumptively mandatory requirements*. The auditor must comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the requirement applies; however, in rare circumstances the auditor may depart from the requirement provided that the auditor documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the requirement. The word *should* is used to indicate a presumptively mandatory requirement.

It is important to note that upon the effective date of the clarified auditing standards the terms describing professional requirements for audit engagements are revised, and are therefore different than those used for attest engagements. See the preceding section for information on defining professional requirements related to auditing standards.

Applicability of U.S. GAAP and PCAOB Standards

Audits of the financial statements of nonissuers (those entities not subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, private entities, generally speaking) are conducted in accordance with GAAS as issued by the ASB, the designated senior committee of the AICPA with the authority to promulgate auditing standards for nonissuers. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA's *Professional Standards*. Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit to comply with the standards promulgated by the ASB. Failure to follow GAAS, and any other applicable auditing standards, is a violation of that rule.

Audits of the financial statements of issuers, as defined by the SEC (those entities subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, public entities, generally speaking), are conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the audits of issuers. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget.

References to Professional Standards

In citing GAAS and its related interpretations, references use section numbers within the codification of currently effective SASs, not the original statement number, as appropriate. In those sections of the guides that refer to specific auditing standards of the PCAOB, references are made to the AICPA's *PCAOB Standards and Related Rules* publication.

AICPA.org Website

The AICPA encourages you to visit the website at www.aicpa.org, and the Financial Reporting Center at www.aicpa.org/FRC. The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process, including accounting, preparing financial statements and performing compilation, review, audit, attest or assurance and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

ASB's Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB has made a significant effort to clarify the SASs. The ASB established clarity drafting conventions and undertook to redraft all of its SASs in accordance with those conventions, which include the following:

- Establishing objectives for each clarified SAS
- Including a definitions section, where relevant, in each clarified SAS
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A- prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bulleted lists, to enhance readability
- Including, when appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the clarified SAS
- Including, when appropriate, special considerations relevant to audits of governmental entities within the text of the clarified SAS

In addition, as the ASB redrafted standards for clarity, it also converged the standards with the International Standards on Auditing (ISA), issued by the International Auditing and Assurance Standards Board. As part of redrafting the standards, they now specify more clearly the objectives of the auditor and the requirements which the auditor has to comply with when conducting an audit in accordance with GAAS.

With the release of SAS Nos. 117–120 and SAS Nos. 122–127, the project is near completion. As of the date of this guide, the only SAS remaining to be clarified is SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, AU-C sec. 610).

Note that SAS No. 122 withdraws SAS No. 26, *Association With Financial Statements, as amended*, from *Professional Standards*.

SAS Nos. 122–127 are effective for audits of financial statements for periods ending on or after December 15, 2012. Refer to individual AU-C sections for specific effective date language.

As part of the clarity project, current AU section numbers have been renumbered based on equivalent ISAs. Guidance is located in "AU-C" section numbers instead of "AU" section numbers. "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections, which will remain in *Professional Standards* through 2013. The "AU-C" identifier will revert to "AU" in 2014, by which time substantially all engagement for which the extant standards were still effective are expected to be completed. Note that AU-C section numbers for clarified SASs with no equivalent ISAs have been assigned new numbers. The ASB believes that this recodification structure will aid firms and practitioners that use both ISAs and GAAS.

All auditing interpretations corresponding to a SAS have been considered in the development of a clarified SAS and incorporated accordingly and have been withdrawn by the ASB except for certain interpretations that the ASB has retained and revised to reflect the issuance of SAS No. 122. The effective date of the revised interpretations aligns with the effective date of the corresponding clarified SAS.

International Financial Reporting Standards

The AICPA governing council voted in May 2008 to recognize the International Accounting Standards Board (IASB) as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of Rule 202 and Rule 203 of the AICPA's Code of Professional Conduct gives AICPA members the option to use International Financial Reporting Standards (IFRSs) as an alternative to U.S. GAAP. As a result, private entities in the U.S. can prepare their financial statements in accordance with U.S. GAAP as promulgated by FASB; a special purpose framework (such as an other comprehensive basis of accounting, or IFRSs, among others. However, domestic issuers are currently required to follow U.S. GAAP and the rules and regulations of the SEC. In contrast, foreign private issuers may present their financial statements in accordance with IFRSs as issued by the IASB without a reconciliation to U.S. GAAP, or in accordance with non-IFRSs home-country GAAP reconciled to U.S. GAAP as permitted by Form 20-F.

The growing acceptance of IFRSs as a basis for U.S. financial reporting may represent a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years. See appendix B, "International Financial Reporting Standards," of this guide for a discerning look at the status of convergence with IFRS in the United States and the important issues that accounting professionals need to consider now.

Private Company Financial Reporting Blue Ribbon Panel

In 2012, the Financial Accounting Foundation established a new body to improve the process of setting accounting standards for private companies. The Private Company Council will decide on exceptions and modifications to U.S. GAAP for private companies and will advise FASB on treatment for private companies for the items on the FASB's agenda. The AICPA released an exposure draft in November 2012 of the financial reporting framework for privately owned, for-profit smaller enterprises that are not required to produce GAAP-based financial statements. For more information visit www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/PCFR/Pages/Financial-Reporting-Framework.aspx.

Purpose and Applicability

Introduction

This guide has been written with the assumption that readers are proficient in accounting and auditing in general, but not necessarily familiar with the airline industry. Accordingly, the guide includes airline industry background and explanatory material.

A glossary of terms and several appendixes have been included to provide the reader with additional sources of information regarding the airline industry. The appendixes are as follows:

- Appendix A, "Mapping and Summarization of Changes—Clarified Auditing Standards"
- Appendix B
- Appendix C, "Schedule of Changes Made to the Text From the Previous Edition"

Limitations

This guide does not discuss the application of all GAAP and all GAAS that are relevant to the preparation and audit of financial statements of airlines. This guide is directed primarily to those aspects of the preparation and audit of financial statements that are unique to airlines or those aspects that are considered particularly significant to them.

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Chapter 1

The Airline Industry

Background

1.01 The United States first began promoting the airline industry through the adoption of the Air Mail Acts of 1925 and 1926, which transferred the carriage of mail from the U.S. Post Office to private carriers. Previously, although there had been interest in the development of military aircraft, private carriers had been unable to generate profits in substantially cargo-related efforts. After passage of the Air Mail Acts, growing demand created by a small but competitive airline industry stimulated the production of aircraft specifically designed for passenger and cargo service.

1.02 The airline industry continued to grow despite the depression of the 1930s. Technological developments and a new network of lighted airports with reliable communication equipment created the environment for industrial growth. In 1938, the Civil Aeronautics Act provided government regulation of market entry and exit, air safety, and rates.

1.03 World War II stymied airline industry growth because military demands limited the amount of equipment and service that was available for civilian passenger service. However, military developments in aviation produced many improvements that would result in more efficient and affordable service.

1.04 Jet service was introduced in the late 1950s. The Federal Aviation Act was passed in 1958, creating the Federal Aviation Administration (FAA), which developed the air traffic control system. Subsequent technological advances and improvements resulted in dramatic increases in property and equipment investment by U.S. scheduled airlines throughout the last half of the century.

1.05 The 1970s saw dramatic increases in costs, particularly increases in fuel prices. In 1978, the Airline Deregulation Act (ADA) amended the Civil Aeronautics Act of 1938 to promote competition in the airline industry while maintaining high standards for safety. After deregulation, many changes occurred in the industry, including a proliferation of smaller regional airlines and low-cost carriers and an increase in mergers and airline bankruptcy filings. This is demonstrated by the fact that 128 airlines filed for bankruptcy in the 18 years following deregulation.

1.06 One of the arguments against deregulation was that some smaller communities would be denied commercial air services. In response, the U.S. Department of Transportation (DOT) implemented the essential air services program. Participating airlines enter into a two-year contract with the DOT, which subsidizes flights and imposes requirements on the number of seats and flights that must be offered and their destinations.

1.07 As previously discussed, many low-cost carriers were founded due to deregulation during the 1970s and continued to expand rapidly through the early 2000s. Low-cost carriers are classified as such due to some of the following cost structures that are different from those of traditional (sometimes also referred to as *legacy*) airlines: simplified fleets, which reduce maintenance costs; a more flexible labor agreement, which results in a more productive

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workforce and greater flexibility in establishing work rules; and limited pension and postretirement benefits, which have become a significant cost for traditional carriers. Although the low-cost carriers' markets have not historically been as extensive as those of traditional airlines, extreme pricing pressure was placed on important routes. Additionally, with the expansion of the Internet in the 1990s, passengers had greater ability to find the lowest fare in booking travel.

1.08 In the 1990s, airlines experienced a strong period of growth, and air travel demand continued to increase. As a result, airlines responded with increased capacity, lower fares, and expansion into more markets.

1.09 Beginning in late 1999 and early 2000, the economy suffered, which resulted in a significant decrease in demand for air travel. The depressed demand for business travel was compounded by the terrorist attacks on September 11, 2001, which had a dramatic effect on the airline industry. Immediately following these tragic events, U.S. airlines experienced numerous difficulties, including a significant drop in demand for air travel, reduced traffic and yields, increased insurance and security costs, and liquidity concerns. In response, the federal government provided assistance to airlines, making federal grants and conditional loan guarantees available. The government also provided relief from increased war risk insurance premiums and limited liability for terrorist attacks. Heightened security concerns resulted in the formation of a new governmental agency, the Transportation Security Administration (TSA), which is responsible for all aviation security. New TSA requirements were the primary factors that contributed to increased security costs covering passenger screening and additional security requirements for aircraft. The airline industry responded with significant cost restructurings, including labor concessions, reductions in force, reductions in capacity via aircraft groundings and scheduling modifications, and bankruptcy filings.

1.10 The years following the events of September 11, 2001, continued to be financially difficult, specifically for the traditional carriers. Compared with historical periods, yields continued to be depressed due to the strong competition from low-cost carriers and reduced demand for air travel. Therefore, the traditional carriers continued various cost-cutting initiatives, which, in addition to reductions in force and labor concessions, included efforts to reduce or eliminate pension and postretirement benefits that constitute a significant component of certain airlines' cost structure. Many of the traditional carriers continued to be highly leveraged, which resulted in additional carriers filing for bankruptcy protection. During this period, the industry also experienced some of the highest prices of fuel, which led to further financial deterioration of many carriers. The high cost of fuel affected both traditional and low-cost carriers; however, due to poor credit ratings, many of the traditional carriers were unable to hedge fuel, which resulted in continued significant operating losses.

1.11 The accounting considerations associated with various airline industry practices summarized in this chapter are discussed further in chapter 3, "Marketing, Selling, and Providing Transportation," through chapter 9, "Regional Airlines."

History of Regulation

1.12 The airline industry has been regulated in three major areas: market entry and exit, rates, and air safety. All three areas of regulatory responsibility came into existence with the Civil Aeronautics Act of 1938. The act created the Civil Aeronautics Board (CAB), whose primary duty, until amended by the ADA, was to promote and regulate the airline industry. The board's mandate was twofold: to maintain the highest priority for safety and to encourage competition in the airline industry. The key elements of deregulation were freedom of market entry and exit and freedom of pricing. A third element was protection of service to small communities.

1.13 The ADA terminated the CAB's authority over rates and route access on January 1, 1983. 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 the legacy 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.

U.S. Government Regulation [1]

Department of Transportation

1.14 The ADA transferred responsibility for overseeing airline operations to the DOT when it was passed in 1978. The DOT is the primary agency that oversees national transportation policy. This includes negotiation of international transportation agreements, preparing transportation legislation, and ensuring the general fitness of U.S. airlines. The DOT is also responsible for approving merger proposals and sales of international airline routes. The secretary of transportation, who is nominated by the president of the United States, heads the DOT.

1.15 The DOT has authority to issue certificates of public convenience and necessity required for airlines to provide domestic air transportation. An airline that the DOT deems fit to operate is given unrestricted authority to operate domestic air transportation, including the carriage of passengers and cargo. Except for constraints imposed by Essential Air Service regulations, which are applicable to certain small communities, airlines may initiate and terminate service to a city without restriction.

1.16 The DOT has jurisdiction over certain economic and consumer protection matters such as unfair or deceptive practices or methods of competition, advertising, denied boarding compensation, baggage liability, and disabled passenger transportation. The DOT also has authority to review certain joint venture agreements between major airlines.

1.17 Authority to operate international routes and international codesharing arrangements is regulated by the DOT and by the foreign governments involved. International route authorities are also subject to the approval of the president of the United States for conformance with national defense and foreign policy objectives.

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[1] This guide does not describe government regulations in countries other than the United States.

1.18 Under federal law and DOT regulations, airlines must be controlled by U.S. citizens. The president of the airline and two-thirds of the board of directors must be U.S. citizens, and not more than 25 percent of outstanding common stock may be voted by non-U.S. citizens. Foreign ownership must be less than 50 percent.

Federal Aviation Administration

1.19 The FAA is a component of the DOT with primary responsibility for the safety of the U.S. air system. The FAA has primary responsibility for matters relating to airline flight operations, including airline operating certificates, control of navigable air space, flight personnel, aircraft certification and maintenance, and other matters affecting air safety. The agency is also responsible for research and development as it pertains to improving our National Airspace System.

1.20 FAA requirements cover security measures, issuance of airworthiness directives, collision avoidance systems, airborne wind-shear avoidance systems, noise abatement and other environmental concerns, commuter aircraft safety, and increased inspections and maintenance procedures to be conducted on older aircraft. The FAA monitors compliance with regulations and may assess fines for noncompliance.

Department of Homeland Security

1.21 Established on March 1, 2003, the Department of Homeland Security (DHS) is responsible for protecting the movement of international trade across U.S. borders, maximizing the security of the international supply chain, and engaging foreign governments and trading partners in programs designed to identify and eliminate security threats before they arrive at U.S. ports and borders.

Transportation Security Administration

1.22 In November 2001, the Aviation and Transportation Security Act (ATSA) was enacted. The ATSA created a new government agency, the TSA, which later became a part of the DHS, which is responsible for aviation security. The ATSA mandates that the TSA provide for the screening of all passengers and property, including U.S. mail, cargo, carry-on and checked baggage, and other articles that will be carried aboard a passenger aircraft. The ATSA also provides for increased security in cockpits of aircraft and requires federal air marshals to be present on certain flights. The operations of the TSA are funded primarily through a passenger security fee, which is a flat fee charged per ticket that the airlines collect and remit to the TSA. Since 2002, the TSA has also imposed an aviation security infrastructure fee on all airlines to assist in the cost of providing aviation security.

Environmental Protection Agency

1.23 The Environmental Protection Agency (EPA) regulates certain aspects of operations, including airline operations, in the United States. Among other things, airlines are subject to the following federal environmental protection laws:

- *Clean Air Act*. The Clean Air Act is the federal law passed in 1970, which, as amended, forms the basis for the national air pollution control effort. Basic elements of the act include national ambient air quality standards for major air pollutants, hazardous air pollutants standards, state attainment plans, motor vehicle emissions standards, stationary source emissions standards and permits, acid rain control measures, stratospheric ozone protection, and enforcement provisions. Aircraft engine emissions can affect local air quality as well as create global atmospheric concerns.

- *Clean Water Act*. Growing public awareness and concern for controlling water pollution led to enactment of the Federal Water Pollution Control Act Amendments of 1972. As amended in 1977, this law became commonly known as the Clean Water Act. The act established the basic structure for regulating discharges of pollutants into the waters of the United States. It gave the EPA the authority to implement pollution control programs such as setting wastewater standards for industry. The Clean Water Act also continued requirements to set water quality standards for all contaminants in surface waters. Jet fuel spills, leaks from underground storage tanks or pipelines used to transport and store jet fuel, and solvents used by aircraft maintenance facilities frequently contaminate water sources.
- *Airport Noise and Capacity Act of 1990*. The Airport Noise and Capacity Act of 1990 recognizes the right of airport operators with special noise problems to implement local noise abatement procedures as long as those procedures do not interfere unreasonably with the interstate and foreign commerce of the national air transportation system. As a result of litigation and pressure from airport area residents, airport operators have taken local actions over the years to reduce aircraft noise. These actions include restrictions on night operations, restrictions on frequency of aircraft operations, and various operational procedures for noise abatement.

Occupational Safety and Health Administration

1.24 The Occupational Safety and Health Administration (OSHA) was created in 1971 with a mission to ensure a safe and healthful workplace in the United States. OSHA sets and enforces standards; provides training, outreach, and education; establishes partnerships; and encourages continuous improvement in workplace safety and health. It intends to act as a leader in joining other health and safety communities in prioritizing health and safety issues and setting a clear agenda for safety consciousness.

Other

1.25 The U.S. Department of Justice has jurisdiction over airline competition matters. The U.S. Postal Service has authority over certain aspects of the transportation of mail. The Railway Labor Act generally governs labor relations in the airline industry.

International Air Transportation

1.26 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 landing rights at specified airports and frequency of flights.

The International Air Transport Association

1.27 The International Air Transport Association (IATA), a voluntary organization of international airlines, was established in 1946 to negotiate international airfares, 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.

1.28 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.

Open Skies or Route Authorities

1.29 The availability of international routes to U.S. airlines is regulated by treaties and related agreements between the United States and foreign governments. The United States typically follows the practice of encouraging foreign governments to accept multiple airline designation on foreign routes, although certain countries have sought to limit the number of airlines allowed to fly these routes to protect their national "flag" airlines. Certain foreign governments impose limitations on the ability of airlines to serve a particular city or airport within their country from the United States. For a U.S. airline to fly to any such international destination, it must first obtain approval from both the United States and the foreign country where the destination is located, which is referred to as a *foreign route authority*. Studies have shown that international routes for which there is a limit to the number of airlines or frequency of flights (such as Heathrow Airport in London) have more value than those without restrictions. Route authorities to some international destinations can be sold between airlines, and their value can vary because of limits on accessibility. To the extent foreign countries adopt "open skies" policies (meaning all airlines have access to the destination), liberalizing or eliminating restrictions on international routes would increase competition and potentially decrease the value of a route authority, subject to airport availability. Please refer to chapter 6, "Other Accounting Considerations," for further discussion of international route authorities and related accounting considerations.

Air Transport Association of America

1.30 Founded in 1936, the Air Transport Association of America (ATA) 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.

1.31 Because travel agent sales, including Internet travel agencies, 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 receivables 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. The ATA provides this service to the airlines and travel agents. A number of low-cost carriers have discontinued using travel agencies in lieu of direct Internet sales, which contributes another factor to their lower cost structure.

1.32 Other plans, called bank settlement plans (BSPs), have been established and are now available in most countries around the world except for certain lesser-developed countries. The BSPs, although not identical to the ASP, contain many of the same features.

Regional Airline Association

1.33 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.

Characteristics of the Industry

Operating Environment

Economy

1.34 Airline profitability is highly sensitive to economic factors, including the ability to attract and retain business and leisure passengers; the effects of any hostilities, acts of war, or terrorist attacks; disease and epidemics; the cost and availability of aircraft insurance; volatility in the cost of aviation fuel; competitive pressures on pricing; and government regulation.

Competition

1.35 The airline industry is highly competitive. Airline profits are sensitive to adverse changes in fuel costs, average fare levels, and passenger demand. Since deregulation, passenger demand and fare levels have been influenced by, among other things, the general state of the economy, international events, industry capacity, and pricing actions taken by other airlines. The principal competitive factors in the airline industry are fare pricing, customer service, routes served, flight schedules, types of aircraft, safety record and reputation, code-sharing relationships, in-flight entertainment systems, and frequent flyer programs.

1.36 International marketing alliances formed by domestic and foreign airlines have increased competition significantly in international markets. Through marketing and code-sharing arrangements with U.S. airlines, foreign airlines have obtained access to domestic U.S. routes. Similarly, U.S. airlines have increased their ability to sell international transportation such as transatlantic services to and beyond European cities.

Seasonality

1.37 In general, demand for passenger air travel in the United States is higher in the June and September quarters because there is more vacation travel during those periods than during the remainder of the year. Demand for air travel is also affected by factors such as economic conditions, war or the threat of war, fare levels, and weather conditions. In addition, demand for air travel at particular airlines may be affected from time to time by, among other things, actual or threatened disruptions to operations due to labor issues.

Airline Classifications

1.38 The DOT classifies U.S. airlines primarily by operating revenue and aircraft size using the following definitions, which are used by the DOT for statistical reporting purposes:

- *Major airline.* A major airline is one that generates more than $1 billion in annual operating revenue. Major airlines often have international operations. Major airlines are also categorized as traditional carriers or low-cost carriers. Many of the low-cost carriers that have grown from the 1970s to the 2000s serve primarily domestic markets.
- *National airline.* A national airline is one that generates between $100 million and $1 billion in annual operating revenue. National airlines operate primarily in the United States.
- *Regional airline.* A regional airline is one that generates less than $100 million in annual operating revenue. Regional airlines are characterized by having a predominantly regional aircraft fleet (fewer than 100 seats per plane) and typically fly within clear geographic boundaries, providing feed and supplementary service to major airlines. The regional airline typically provides such supplementary service to one or two major airlines under a capacity purchase agreement.
- *Air cargo carrier.* Air cargo carriers specialize in the transportation of mail, parcels, and freight.

1.39 The DOT specifies these definitions. Industry participants, however, frequently refer to the airlines based on the following criteria (the operating models referred to in this section are defined in paragraphs 1.40–.42):

- *Network* or *major carrier* generally refers to legacy carriers that existed before airline deregulation and have traditionally operated under a hub-and-spoke system.
- *Low-cost carrier* generally refers to carriers established after deregulation that focus on point-to-point operations and generally have only one class of service.
- *Regional carrier* refers to carriers that generally provide either contract flying or connecting service for a network carrier.

Operating Models

1.40 Airlines typically operate using the hub-and-spoke model or the point-to-point model, but some airlines use a combination of both models.

1.41 The hub-and-spoke system concentrates most of an airline's operations in a limited number of hub cities, serving most other destinations in the system by providing one-stop or connecting service through the hub between destinations on the spokes. Such an arrangement permits travelers to fly from a point of origin to more destinations without switching airlines. Hub airports permit airlines to transport passengers between large numbers of destinations with substantially more frequent service than if each route were served directly.

1.42 The point-to-point model spreads the airline's resources over a number of cities and focuses on providing high frequency, point-to-point service (flying from one city to another without stopping in a connecting city). This typically results in higher aircraft utilization and allows fixed costs to be spread over more hours of flying.

Other

1.43 Many airlines offer charter service to the public. In addition, many airlines participate in the Civil Reserve Air Fleet (CRAF) program. In time of war or during an unlimited national emergency or civil defense emergency, airlines can be required to provide airlift services to the Air Mobility Command under the CRAF program. Both mandatory and voluntary missions are a part of this program.

1.44 Many major airlines offer both domestic and international cargo, freight, and mail shipping services.

Fuel

1.45 Fuel costs constitute a significant portion of operating expenses for all airlines. The effect of fuel price changes on an individual airline depends upon various factors, including the airline's hedging strategy.

1.46 In the event there is an outbreak of hostilities or other conflicts in oil-producing areas of the world, there could be reductions in the production or importation of crude oil or significant increases in the cost of fuel. If there were major reductions in the availability of jet fuel or significant increases in its cost, the entire airline industry would be adversely affected.

1.47 Since the mid-2000s, the fuel prices have been historically high and extremely volatile. Given the significance of fuel costs to airline operations and the volatility of fuel prices, airlines typically engage in hedging programs to mitigate price risk. However, after September 11, 2001, the low-cost carriers typically have been the primary carriers able to initiate substantial hedging programs due to the significant decline in the creditworthiness of the traditional carriers. Please refer to chapter 6 for further discussion of fuel hedging.

Taxes and Fees

1.48 The U.S. airline industry is one of the most heavily taxed of all industries. Taxes and fees represent approximately 25 percent of the price of an average airline ticket, including customs and excise tax, foreign departure taxes, fuel taxes, security fees, and airport passenger facility charges. These taxes and fees have increased significantly in the past decade, most recently with the introduction of a security fee imposed on each passenger flight segment, which is being collected by the airlines and submitted to the government to pay for enhanced security measures after September 11, 2001. Security fees have been assessed by the government based on the airline's historical passenger screening costs but may also be assessed based on the airline's market share or on some other basis as determined by the government. A myriad of international taxes exist that are as varied as the countries assessing them, such as stamp taxes, departure taxes, and value-added taxes. Many of these taxes are collected at the time of sale but remitted at departure based on the number of passengers boarded. Please refer to chapter 3 for further discussion of taxes and fees and related accounting considerations.

Insurance

1.49 Airlines carry insurance to cover public liability, passenger liability, property damage, war risk, and all-risk damage to their aircraft. As a result of the events on September 11, 2001, aviation insurers have significantly reduced the amount of insurance coverage available to commercial airlines for liability to persons other than employees or passengers for claims resulting from acts of terrorism, war, or similar events (war-risk coverage). At the same time, they significantly increased the premiums for such coverage as well as for aviation insurance in general. Accordingly, such coverage is periodically supplemented by the U.S. government. Please refer to the "Insurance" section in this chapter for an in-depth discussion of airline insurance programs.

Maintenance

1.50 Maintenance costs represent a significant portion of the combined operating expenses of airlines. To make maintenance more efficient, some airlines have entered into pooling agreements. Pools of materials and parts are maintained separately by the individual airlines and made available to other airlines as required. Benefits result from reduced inventory requirements.

1.51 In recent years, in an effort to reduce maintenance costs, many airlines have resorted to having maintenance performed by independent maintenance providers. As a result, a number of new developments have occurred in the maintenance and engineering arena. Those developments include (*a*) power-by-the-hour contracts with independent maintenance and repair entities, wherein the airline pays the service provider a fixed amount per flight hour in exchange for maintenance and repairs, or other agreements with payments based on actual time and materials costs and (*b*) maintenance joint ventures between an airline and an independent maintenance and repair entity to perform maintenance and repairs primarily on the airline's airframes and engines and perhaps those of other airlines as well. In addition, many lease agreements now include various provisions for maintenance. Please refer to maintenance accounting considerations discussed in chapter 4, "Acquiring and Maintaining Property and Equipment."

Unionization

1.52 Labor relations are a significant factor in the airline industry. The existence of several unions per airline means that contract negotiations may be in progress constantly. Airline industry employee unions are governed by the Railway Labor Act of 1926, which permits Congress to intervene in the negotiation or settlement of strikes that create a national emergency by threatening to cripple the transportation industry. The Railway Labor Act and the associated accounting considerations are discussed further in chapter 5, "Employee-Related Costs."

1.53 Labor unionization makes restructuring efforts by traditional carriers difficult given the work rules established in contracts, the seniority pay systems, and the substantial retirement benefits.

Marketing Strategy

Distribution Channels

1.54 Most airlines sell tickets through Global Distribution Systems (GDSs), including Amadeus, Galileo, Sabre, SystemOne, and WorldSpan. These systems provide flight schedules and pricing information and allow travel agents to process a flight reservation electronically without contacting an airline's reservations facility. Travel agents' reliance on GDSs has, from time to time, significantly increased the cost of making reservations, which is borne primarily by airlines that subscribe to the GDS. Airlines historically also paid commissions to travel agencies, but, with the growth of Internet travel websites, most domestic commissions have been eliminated. Many travel agencies now assess a separate fee on customers.

1.55 Most airlines also have a direct reservation option, either through call centers or their website. To attract customers to their websites, the airlines provide discounts to customers who book reservations on their websites.

1.56 There has also been a significant increase in Internet travel websites, including Priceline©, Orbitz©, Expedia©, and Hotwire©. The advent of these websites has not only resulted in significant distribution cost savings for airlines but has also had a negative effect on airline revenue. Having access to "perfect pricing information," air travel consumers have become more efficient at finding lower fare alternatives than in the past. The increased price consciousness of travelers, as well as the growth in distribution channels, has further motivated airlines to price aggressively to gain fare advantages through certain channels. Airlines' distribution channels are further discussed in the "Sales Reporting" section of chapter 3.

Airline Alliances

1.57 Several types of arrangements allow two or more airlines to coordinate services to their customers. A code-sharing arrangement enables a ticketing airline to issue tickets on the operating airline and to use that operating airline's two-letter code when doing so in computer reservation systems. Such alliances also usually tie in each airline's marketing and frequent flyer programs and provide for schedule coordination for convenient connections between airlines. Please refer to chapter 3 for further discussion of airline alliances and related accounting considerations.

1.58 In addition, major airlines have agreements with regional airlines that permit the major airlines to expand their overall network and maximize their existing route structure by providing a greater number of travel options to customers. Under traditional revenue sharing agreements, regional airlines generally received a prorated portion of the passenger ticket revenue plus an incentive to connect the passengers to the longer segment, flown by the major airline. However, with the advent of regional jets, a number of the arrangements with the regional airlines were changed to capacity purchase agreements. Under these arrangements, the major airline purchases the entire capacity of the aircraft at a specified cost. The major airline generally pays the regional airline a rate based on certain flying statistics, such as block hour, with additional incentives and penalties based on such factors as completion of flights, on-time performance, and satisfactory baggage handling. The major airline is responsible for scheduling the regional airline's flights, determining pricing, and selling the tickets. The major airline retains the revenue pricing risk and bears the risk of changes in the price of fuel, which, in turn, shelters the regional to some degree from many of the elements that cause volatility in airline earnings. Major airlines use capacity purchase agreements because these agreements allow them to expand their operations at lower fixed costs, thereby enabling them to serve strategic routes that otherwise might be uneconomical. Major airline alliances with regional carriers are further discussed in chapter 3 (from the major airline's perspective) and chapter 9 (from the regional airline's perspective).

Frequent Flyer Programs

1.59 Frequent flyer programs, which began in the 1980s to encourage travel and promote customer loyalty to a respective airline, have resulted in significant revenue from other entities that pay for access to airline customer lists and trade names and who provide frequent flyer miles to their customers in exchange for various purchases. Those entities include cooperative partners, which are primarily credit card companies, hotels, and other travel service providers. Additionally, through the code-share arrangements previously discussed, airlines have entered into frequent flyer arrangements with certain code-share partners and issue miles for travel on each other's airlines. Please refer to chapter 3 for further discussion of frequent flyer programs and related accounting considerations.

Airline Investments

Aircraft Fleet

1.60 The airline industry is characterized by substantial aircraft investment. Because of traffic projections and lengthy production schedules, most airlines acquire aircraft fleets over a number of years. The large manufacturers typically require progress payments (purchase deposits) during the manufacturing period, with balloon payments upon delivery. New fleet acquisitions also require a significant capital outlay for spare parts to support the aircraft. The rapid development of technological advances and substantial plant and equipment investment needs have created large capital requirements, which cannot be met by internal funding alone. Cyclical earnings also hamper the ability of some airlines to raise money through equity and unsecured debt issues. This has increased reliance on secured debt, leasing, and other similar forms of financing. The large financing requirements that are characteristic of the industry make ownership costs (depreciation, interest, and rent expense) a major component of an airline's fixed costs.

1.61 The number of aircraft types in a fleet can affect many aspects of an airline's operating expenses. A simplified fleet can help an airline save on maintenance and training costs because mechanics and flight crews need to be knowledgeable on fewer aircraft types. In addition, spare parts inventory requirements are reduced because the airline needs to hold parts for fewer aircraft types.

1.62 The age of the aircraft is also important because a younger fleet tends to be more fuel efficient and requires less maintenance than an older model aircraft. Please refer to chapter 4 for further discussion of airline fleet and related accounting considerations.

Airport Facilities

1.63 Local governments play a major role in air transportation by financing, owning, and operating terminal facilities necessary for air travel. Generally, the cost of terminal facilities and their maintenance are reimbursed by the airlines through landing fees, charges for terminal facility rentals, and passenger facility charges (PFCs). Please refer to chapter 10, "Special Reports and Example Reporting," for further discussion of PFCs and related reporting requirements.

1.64 In some cases, airlines initially fund construction and modifications and are later reimbursed from proceeds of bond issues, rental credits, or both. Municipalities, through airport authorities, often finance the acquisition and construction of various facilities and equipment by issuing special facility revenue bonds. An airline will often guarantee these bonds and enter into a special facility lease agreement as the lessee to use the facilities and equipment constructed with the proceeds of the bonds. Please refer to chapter 6 for further discussion of airport financings and related accounting considerations.

1.65 Ground handling services typically can be categorized as follows: public contact, under-wing ground handling, and complete ground handling. Public contact services involve meeting, greeting, and serving customers at the check-in counter, gate, and baggage claim area. Under-wing ground handling services include marshaling the aircraft into and out of the gate, baggage and mail loading and unloading, lavatory and water servicing, de-icing, and certain other services. Complete ground handling consists of public contact and under-wing services combined.

Fuel Facilities

1.66 Airlines usually participate in numerous fuel consortiums with other carriers at major airports to reduce the costs of fuel distribution and storage. Agreements govern the rights and responsibilities of the consortium members and provide for the allocation of the overall costs to operate the consortium based on usage. The consortiums (and in limited cases, the participating airlines) have entered into long-term agreements to lease certain airport fuel storage and distribution facilities that are typically financed through tax-exempt bonds (either special facilities lease revenue bonds or general airport revenue bonds) issued by various local municipalities. Please refer to chapter 6 for further discussion of fuel facilities and related accounting considerations.

Routes, Slots, and Gates

1.67 Certain very high density airports have a fixed number of takeoff and landing times (slots) available, as designated by the U.S. government to avoid excessive congestion. The rights to these slots may be sold or traded by the airline that owns the rights to the slots. These transactions generally include the sale of a gate or access to gates. Slots and gates, particularly those in high demand, have value and represent intangible assets.

1.68 Intangible assets also typically include international route authorities. Traditionally, foreign countries limited access to routes from the United States to protect their national airlines from too much competition. International route authorities and access to the airports by U.S. carriers are governed by bilateral aviation agreements that can limit the number of airlines that may provide service to certain airports and can restrict service by aircraft types, frequency, or destination. Please refer to chapter 6 for further discussion of routes, slots, and gates and related accounting considerations.

Insurance

1.69 Insurance programs for airlines normally include aviation, hull, and terrorism insurance; building and contents; executive protection programs; fiduciary liability; home, kidnap, and ransom insurance; directors' and officers' liability; group and workmen's compensation insurance; and other typical insurance programs. Although most of these programs are comparable to the insurance programs of other industries, there are several unique insurance programs directly related to the airline industry, including aviation, hull, and terrorism insurance, that are discussed in the following sections.

Aviation Insurance

1.70 Aviation insurance for passenger liability relates to the coverage of risks associated with providing air transportation services to passengers and residual risks to people and property on the ground. This includes catastrophic accidents as well as routine passenger-related claims. Environmental coverage within aviation is typically extremely limited.

1.71 Aviation insurance, in general, is provided by a front, or lead insurer, that provides claim handling services and administrative support. In some cases, lead insurers are paid a fee for services rendered in addition to their syndicated share of insurance premiums. Additional insurers subscribe to this lead policy to complete the overall offering of insurance to spread the catastrophic risk of accidents over a larger capital base, much like banks syndicate significant loans to limit default exposure. A major airline may have 10 to 20 insurers subscribing to a lead policy, providing varying levels (1 percent to 20 percent) of financial capacity in support of the overall insurance limit. The limit of insurance offered collectively by the syndicate ranges from $500 million per accident or incident for smaller regional airlines to well in excess of $1 billion for major U.S. airlines. All airline aviation insurance is purchased through insurance brokers, which are typically compensated either on a commission basis on premiums paid or on a fee basis directly from the airline.

1.72 Premiums are normally determined on the basis of a rate per passenger mile or departure flown. The insurance rate charged is normally fixed, whereas the exposure basis, such as passenger miles flown, departures, cargo ton miles, passenger enplanements, or other measure of flying activity, is variable. Aviation insurance premiums are typically established as a deposit premium at the beginning of the policy year based on management's projections of flying activity and are adjusted at policy year end based on the actual flying activity, with a resulting refund or additional premium due.

Hull Insurance

1.73 Hull insurance covers damage to flight equipment, spare parts, and aircraft in the airline's care, custody, and control (including when the airline provides maintenance for fee to other airlines) while in the air or on the ground. Hull insurance rates are normally based on dollar value of insured equipment. The insured value of equipment may be determined in several ways: net book value, replacement cost, estimated fair value, or as contractually defined in operating or financing leases (in the event of total loss). The rate applicable to insured value of equipment is normally fixed; however, premiums are also adjusted at year end based on actual values insured during the course of the year to reflect deliveries of new aircraft, sales, or material adjustment in asset valuation (such as what occurred following the events of September 11, 2001, in terms of significant reduction of aircraft values industry wide). Typically, there is a reduced premium rate for "grounded" or excess aircraft not in use.

Terrorism Insurance

1.74 The following paragraphs describe terrorism insurance and are reproduced with permission of the publisher, International Risk Management Institute, Inc., Dallas, Texas, from *Terrorism Insurance: What Risk and Insurance Professionals Must Know*, copyright International Risk Management Institute, Inc. Further reproduction prohibited. For subscription information, phone 800-827-4242. Visit www.IRMI.com for reliable and practical risk and insurance information.

> *Terrorism insurance for airline hull and liability (also referred to as war risk insurance) was a relatively inexpensive coverage prior to September 11, 2001. For major U.S. airlines, the total cost of war risk for hull and liability was 2 to 4 cents per passenger, or perhaps $30 to $50 million for the U.S. airline industry in total. It was sold as a stand-alone insurance program for hull war risk, and on the liability side, as an endorsement to an airline "all risk" policy. Both coverages contained a 7 day notice of cancellation, typically used to re-price the coverage, or restrict coverage for certain geographic hot spots.*
>
> *The week after the terrorist attacks of September 11, 2001, aviation insurers worldwide issued notice of cancellation to all commercial airlines. Insurers offered reinstatement terms, but at dramatically higher prices (i.e., $1.25 per passenger, or approximately $750 million premium annualized for all U.S. airlines), plus reduction of limits to a standard $50 million as respects damage to people and property on the ground to reduce future exposures to mass ground casualties. Due to the contractual obligations of the airlines, as well as insurance limit requirements imposed for flying into certain countries, the insurance limits offered by the market were not sufficient for airlines to fly, in effect grounding airlines worldwide.*
>
> *Various countries responded to this crisis in different ways. In some countries, the government provided indemnification for non-passenger losses. In others, particularly smaller countries whose indemnification would not be considered sufficient financial security, the government forced the airlines to purchase what limited excess insurance was offered, adding yet another extreme cost to the airline. Other countries, including the United States, enacted legislation to provide insurance to close the gap, charging a premium for this coverage. The Airline Stabilization Act of (September) 2001 authorized the Federal Aviation Administration (FAA) to provide excess insurance above the $50 million commercially provided limit, which allowed U.S. airlines to continue to operate. The Act also capped third party liability claims brought in the U.S. to $100 million for a terrorist event.*
>
> *For U.S. air carriers, this system stayed in place until December of 2002, when the Homeland Security Act authorized the FAA to broaden its coverage beyond third party liability to provide hull, passenger and*

third party war risk insurance for the airlines for a defined premium, along with reauthorizing the $100 million cap.

1.75 The Homeland Security Act of 2002 required the FAA to provide war risk hull loss and passenger, crew, and third-party liability insurance through August 31, 2003. Coverage under this Act has subsequently been extended several times. Although the price of commercial insurance has declined since the premium increases immediately after the events of September 11, 2001, if the U.S. government does not continue to extend its insurance policy it will have a significant effect on the airlines.

Chapter 2

General Auditing Considerations[1]

Update 2-1 *Audit*: Clarified Auditing Standards

The auditing guidance in this guide edition has been conformed to Statement on Auditing Standards (SAS) Nos. 122–127 (referred to as clarified SASs), which were issued as part of the Auditing Standards Board's (ASB's) Clarity Project. These clarified SASs are effective for audits of financial statements for periods ending on or after December 15, 2012. Although extensive, the revisions to generally accepted auditing standards (GAAS) resulting from these clarified SASs do not change many of the requirements found in the auditing standards that they supersede.

To assist auditors and financial reporting professionals in making the transition, this guide includes appendix A, "Mapping and Summarization of Changes—Clarified Auditing Standards," which provides a cross reference of the sections in the superseded auditing standards to the applicable sections in the clarified auditing standards and identifies the changes, either substantive or primarily clarifying in nature, that may affect an auditor's practice or methodology relative to the applicable sections of SAS Nos. 122–127. It also summarizes the changes resulting from the requirements of SAS Nos. 122–127.

The preface of this guide and the Financial Reporting Center on www.aicpa.org provide more information on the Clarity Project. Visit www.aicpa.org/sasclarity.

Introduction

2.01 In accordance with AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), an independent auditor plans, conducts, and reports the results of an audit in accordance with GAAS. Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This chapter of the guide provides guidance primarily on the application of the standards of fieldwork. Specifically, this chapter provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and general auditing considerations for an engagement to audit financial statements of an airline.

2.02 Independent auditors often encounter a variety of complex issues in audits of entities in the airline industry because of the unique nature of operations in the industry, specialized accounting systems, specifically as it relates to revenue recognition and because of the complex accounting issues present in industry accounting.

2.03 An initial step in any audit is to become knowledgeable about the airline and the competitive and economic environment in which the entity

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[1] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

operates. Toward this end, chapter 1, "The Airline Industry," of this guide discusses the general nature of the airline industry. Chapters 3, "Marketing, Selling, and Providing Transportation," through 9, "Regional Airlines," provide a general discussion of accounting issues and generally accepted accounting principles (GAAP) relating to the airline industry. Chapter 10, "Special Reports and Example Reporting," discusses certain types of attestation engagements performed for airlines and contains examples of special reports issued in connection with those engagements.

Scope of This Chapter

2.04 These general auditing guidelines are not intended to mandate auditing procedures to be applied in every audit of an airline. Nor is the list of typical controls over significant processes in exhibit 2-1 intended to prescribe the types of controls to be implemented in all circumstances. The types of controls expected to be in place and the audit procedures performed by the auditor will vary depending on the nature of the operations and the auditor's assessment of the risks of material misstatement. Additionally, if the auditor is performing an audit of internal control over financial reporting in accordance with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), additional consideration would be given to internal control and its effect on the audit approach.

2.05 The objective of this chapter is to assist the independent auditor in applying PCAOB and GAAS standards in audits of the financial statements and internal control over financial reporting of entities in the airline industry. Please refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface). This chapter is not intended to provide specific guidance to auditors on how to comply with the requirements of the PCAOB. However, the information included in the "Understanding of Internal Control" part of this chapter and in the exhibits to this chapter addresses key details on the consideration of internal control over financial reporting unique to the airline industry, such as significant accounts, significant processes, and normative controls over these processes. This information would be appropriate for use in both the GAAS audit of financial statements and an integrated audit that would comply with the requirements of the PCAOB. The term *audit* generally refers to the audit of financial statements unless it is indicated that the discussion pertains to the integrated audit or an audit of an entity's internal control over financial reporting.

Planning and Other Auditing Considerations

2.06 The objective of an audit of an airline's financial statements is to express an opinion on whether its financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows for the specified period ended in conformity with GAAP or a special purpose framework. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to the airlines.

Audit Planning

2.07 AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS; preliminary engagement activities; preparing a detailed, written audit plan; and determining the extent of involvement of professionals with specialized skills. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal controls. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When planning for an engagement to perform an audit over financial reporting in accordance with PCAOB standards, the auditor should refer to Auditing Standard No. 9, *Audit Planning* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards).
>
> Additionally, when performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards (subsequently referred to as "integrated audit"), the auditor should refer to paragraph 9 of Auditing Standard No. 5 regarding planning considerations.

2.08 Paragraph .09 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), states that during planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud along with other information gathered in the process of identifying the risks of material misstatements.

Establishing an Understanding With the Client

2.09 Paragraph .06 of AU-C section 300 states that the auditor should establish an understanding with the client regarding the services to be performed for each engagement. AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), provides guidance on what should be included in this understanding. This understanding should be documented through a written communication with the client in the form of an engagement letter. The understanding should include the objectives and scope of the engagement, the responsibilities of management and the auditor, and any limitations of the engagement. AU-C section 210 also identifies specific matters that generally would be addressed in the understanding with the client and other contractual matters an auditor might wish to include in the understanding.

2.10 Although there are many topics that the auditor may consider discussing with the client prior to commencing the audit, the elements that may be unique or significant in the audit of an airline could include the following:

- The effect of the use of service organizations on audit procedures related to reservations systems, IT outsourcing, and ticketing processing and scanning centers
- Inquiries about current business developments affecting the airline, such as the introduction of new routes, charges to frequent flyer arrangements, aircraft purchase agreements, new or amended lease or debt agreements, amendable labor agreements, new joint business alliance agreements, new liquidity arrangements, outsourcing of various back-office processes, and changes in reservation systems or key accounting systems
- New capacity purchase agreements (especially from the regional airline prospective)
- Reliance on the work of internal audit
- Availability of actuarial reports to support valuation of key accounting estimates such as pensions, other postemployment benefits, workers compensation, and other employee related accruals
- Audit timing, including dates for the following:
  - — Availability of records
  - — Delivery of the report, which may be affected by legal and contractual provisions
- Reports to be provided by the auditor pursuant to the terms of the engagement such as reports on passenger facility charges or other special reports are discussed in chapter 10 of this guide.

This list included information that is also helpful during the risk assessment phase of the engagement.

Considerations for Audits Performed in Accordance With PCAOB Standards

When performing an integrated audit, the auditor should refer to paragraphs 5–7 of Auditing Standard 16, *Communication with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which includes requirements specific to an integrated audit related to (1) the objective of the audit, (2) the responsibility of the auditor for conducting the audit in accordance with PCAOB standards, and (3) the responsibility of the auditor for communicating certain matters in writing to various parties, including the audit committee and management.

Audit Risk

2.11 Paragraph .A36 of AU-C section 200 explains that audit risk is a function of the risk of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

2.12 Paragraphs .A38–.A40 of AU-C section 200 provide further explanation on the two levels of the risks of material misstatement. The risks of material misstatement exist at the overall financial statement level and the assertion level for classes of transactions, account balances, and disclosures.

Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

2.13 Paragraph .A44 of AU-C section 200 explains that GAAS do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms.

2.14 In considering audit risk at the overall financial statement level, the auditor should assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Risk of Material Misstatement

2.15 AU-C section 200 and other sections in AICPA *Professional Standards* describe the risks of material misstatement is the combination of two components: inherent risk and control risk. GAAS do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

2.16 *Inherent risk*. Inherent risk is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures than for others. In assessing inherent risk, the following factors may be considered; however, the presence of a number of factors in isolation would not necessarily indicate increased risk.

2.17 *Management characteristics*. The following management characteristics may indicate increased inherent risk:

a. One person dominates management's operating and financing decision making process.

b. Management places undue emphasis on meeting earnings projections, share price, industry targets, maintaining or improving yield.

c. Management places undue emphasis on achieving certain results in order to communicate or disclose financial information to labor unions.

d. Management compensation is significantly influenced by earnings, share price, or other contract characteristics.

e. Management lacks experience in addressing the airline industry issues, emerging issues, or other complex matters.

f. Staff turnover is high, personnel are inexperienced, or staff levels are insufficient given the volume or kind of business processed.

g. Decision making is decentralized and lacks adequate monitoring if in various operating segments.

2.18 *Operating and industry characteristics*. The following characteristics pertaining to operations and the industry may indicate increased inherent risk:

a. Key financial indicators of the airline significantly differ from industry averages or are inconsistent with the entity's historical operations.

b. The airline is poorly rated by the rating agencies or has had a recent change in rating.

c. Operating results significantly differ from projected results.

d. Market share is changing due to increased competition.

e. Operating results are highly sensitive to factors such as economic conditions, war or the threat of war, fare levels, severe contagious diseases, or weather conditions. In addition, demand for air travel at particular airlines may be affected from time to time by, among other things, actual or threatened disruptions to operations due to labor issues.

f. Significant off-balance sheet risks exist including variable interest entities in leasing structures.

g. Complex nature of hedging arrangements.

h. Internal or external circumstances raise substantial doubt about the airline's ability to continue as a going concern.

i. A large number of reporting units or segments in the airline.

j. Economic dependence of a subsidiary on the mainline operations.

k. Regional airlines significant disputes or disagreements in settlement of billings for capacity purchase agreements.

2.19 *Engagement characteristics*. The following characteristics pertaining to an engagement may signal increased inherent risk:

a. Contentious or difficult accounting issues are present.

b. Unusual transactions entered into during the year such as derivative instruments or complex leasing transactions.

c. The number and complexity of various types of contracts have increased. For example, lease structures, fuel facility structures, or hedging arrangements entered into during the year.

d. The number or amounts of adjustments in prior periods have been significant.

e. Significant estimates in prior years have not proven to be materially accurate based on a retrospective assessment in such areas as breakage related to frequent flyer programs and revenue recognition or provisions for aircraft valuations.

f. Investigations or significant inquiries by regulators.

g. Increased risk associated with pressure to meet debt covenants or other liquidity metrics (for example, credit card holdback covenants).

2.20 Examples of inherent risks for specific areas are included in the respective accounting chapters of this guide.

2.21 *Control risk.* Control risk is the risk that a misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

2.22 Certain characteristics of an entity's internal control over financial reporting, particularly in the control environment, may be unique to airlines and, therefore, would be considered in the control risk assessment. These items may include such things as

- use of service organizations for passenger revenue processing, benefits administration, back-office functions, and IT infrastructure.
- e-ticketing and booking over the Internet.
- control systems for spare parts, materials, and supplies for aircraft maintenance.
- control over systems used to track frequent flyer programs.
- controls over complex revenue accounting systems, including those associated with a large volume of transactions.
- management estimates, including the entity's value of intangible assets, breakage and interline reserves.
- turnover of accounting personnel in financially distressed carriers.

Detection Risk

2.23 *Detection risk* is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors might be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, supervision and review of the audit work performed, and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Detection risk can be disaggregated into additional components of tests of details risk and substantive analytical procedures risk.

Materiality

2.24 The auditor's consideration of materiality is a matter of professional judgment and is affected by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

2.25 In accordance with paragraph .10 of AU-C section 320, *Materiality in Planning and Performing and Audit* (AICPA, *Professional Standards*), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. Generally, profit is used for airlines that are consistently profitable. However, because many airlines have historically had significantly fluctuating results (including swings from profit to loss), auditors have traditionally looked to a percentage of revenue when determining materiality.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit of financial statements and internal control over financial reporting, refer to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding materiality considerations.

Performance Materiality

2.26 Paragraph .A14 of AU-C section 320 explains that planning the audit solely to detect individual material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements. Therefore, in accordance with paragraph .11 of AU-C section 320, the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. *Performance materiality*, for purposes of GAAS, is defined in AU-C section 320 as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement, which is the application of performance materiality to a particular sampling procedure.[2]

2.27 Paragraph .A14 of AU-C section 320 goes on to explain that the determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk

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[2] AU-C section 530, *Audit Sampling* (AICPA, *Professional Standards*), defines *tolerable misstatement* and provides further application guidance about the concept.

assessment procedures, and the nature and extent of misstatements identified in previous audits and, thereby, the auditor's expectations regarding misstatements in the current period.

Assessment of Risks of Material Misstatement at the Assertion Level

2.28 Paragraph .05 of AU-C section 315 states that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the account balances and classes of transactions in the financial statements and related disclosures. Relevant assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following categories and may take the following forms:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ valuation and allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.

(continued)

Categories of Assertions—*continued*

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

2.29 According to paragraph .A116 of AU-C section 315, the auditor should use relevant assertions for classes of transactions, account balances, and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by relating the identified risks to what can go wrong at the relevant assertion, taking account of relevant controls that the auditor intends to test, and designing further audit procedures that are responsive to the assessed risks.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 11–12 of Auditing Standard No. 15, *Audit Evidence* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding the use of assertions. See the "Exhibits" section of this chapter for explanation of differences between the AICPA and PCAOB standards as it relates to assertions.

2.30 The exhibits to this chapter provide guidance on identification of significant accounts and relevant assertions including significant processes and key controls that support those accounts that are unique to the airline industry.

Understanding the Entity, Its Environment, and Its Internal Control

2.31 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

2.32 Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an *understanding of the entity*), is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. As stated in paragraph .A1 of AU-C section 315, the understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with AU-C section 320;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- developing expectations for use when performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

2.33 This section addresses the unique aspects of airlines that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

Risk Assessment Procedures

2.34 In accordance with paragraph .05 of AU-C section 315, the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. For purposes of GAAS, *risk assessment procedures* are defined in AU-C section 315 as audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.

2.35 The auditor is required to exercise professional judgment to determine the extent of the required understanding of the entity. Paragraph .A3 of AU-C section 315 states that the auditor's primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objectives of AU-C section 315. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

2.36 In accordance with paragraph .06 of AU-C section 315, the risk assessment procedures should include the following:

a. Inquiries of management and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error

b. Analytical procedures (See the "Analytical Procedures" section in this chapter for a discussion and examples of analytical procedures.)

c. Observation and inspection

2.37 See paragraphs .06–.13 of AU-C section 315 for additional requirements on risk assessment and related activities.

Discussion Among the Audit Team

2.38 In accordance with paragraph .11 of AU-C section 315, the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. Paragraph .A14 of AU-C section 315 states this discussion may be held concurrently with the discussion among the engagement team that is required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Entity and Its Environment, Including the Entity's Internal Control

2.39 Paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the following:

a. Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework.

b. The nature of the entity, including

   i. its operations;

   ii. its ownership and governance structures;

   iii. the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and

   iv. the way that the entity is structured and how it is financed,

   to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

d. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.

e. The measurement and review of the entity's financial performance.

2.40 Appendix A, "Understanding the Entity and Its Environment," of AU-C section 315 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment. Appendix B, "Internal Control Components," of AU-C section 315 contains a detailed explanation of the internal control components.

2.41 Refer to chapter 1 of this guide, which discusses regulatory environment, characteristics of the industry, as well as business risks.

2.42 As discussed in paragraph .A5 of AU-C section 315, the auditor may complete other procedures in order to better understand the entity and its environment, the auditor of an airline may consider applying the following procedures:

- *a.* Review periodic reports to the Securities and Exchange Commission and agencies such as the Department of Transportation (DOT).
- *b.* Refer to websites of such associations as Bureau of Transportation Statistics (www.bts.gov/programs/airline_information/), the Air Transport Association of America (www.airlines.org/), and the International Air Transport Association (www.iata.org/index.htm) as good information sources.
- *c.* Read reports from the airline's service organizations' auditors, other independent auditors, and internal auditors. After reading these reports, communications may be necessary with the preparer of these reports to determine the extent of audit procedures or the practitioners' ability to rely on the content of any of these reports.

2.43 In fulfilling the requirements under paragraph .10 of AU-C section 315, the auditor may find it helpful to maintain an audit documentation file that may include the following documents particular to an airline:

- *a.* Contracts and agreements, such as aircraft and facility leases, aircraft purchase agreements, capacity purchase agreements, collective bargaining agreements, and other agreements with third parties
- *b.* Loan agreements, bond indentures, and other debt instruments
- *c.* Frequent flyer affiliate arrangements (that is, contracts to serve and settle program miles), including any related presale arrangements
- *d.* Alliance agreements
- *e.* Benefit plan agreements including pensions, share based compensation agreements, and profit sharing agreements
- *f.* Information about officers and directors
- *g.* Relevant sections of union agreements (for example, severance payments and other benefits)
- *h.* Power by the hour maintenance contracts

Understanding of Internal Control

2.44 Paragraphs .13–.14 of AU-C section 315 state that the auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.

2.45 Obtaining an understanding of controls should be distinguished from testing the operating effectiveness of controls. The objective of obtaining an understanding of internal controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

2.46 Paragraph .A44 of AU-C section 315 explains that internal control is designed, implemented, and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern the reliability of the entity's financial reporting, the effectiveness and efficiency of its operations, and its compliance with applicable laws and regulations.

2.47 Internal control consists of five interrelated components:

a. The control environment

b. Risk assessment

c. Information and communication systems

d. Control activities

e. Monitoring

2.48 Refer to AU-C section 315 for a detailed discussion of the internal control components. Those paragraphs recognize the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission.

2.49 Auditors of some issuers are also required to perform an audit of the entity's internal control over financial reporting that is integrated with their audit of the entity's financial statements. Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of the financial statements. This chapter is not intended to provide guidance to auditors on how to comply with the requirements of Auditing Standard No. 5, although it refers the readers, as appropriate, to selected paragraphs in that standard for additional guidance that should be considered when performing an integrated audit.

2.50 Exhibit 2-1 provides a summary of the processes significant to airlines along with the controls that often mitigate the control risk for each respective assertion applicable to those processes.

Information Technology

2.51 According to paragraph .A54 of AU-C section 315, an entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. The use of IT also affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported. Paragraph .19 of AU-C section 315 states that the auditor should obtain an understanding of the information system, including the related business purposes relevant to the financial reporting. Because of the volume and complexity of transactions associated with airline operations, the auditor can expect to encounter the use of IT, ranging from smaller carriers' limited use through service bureaus, to extensive use of sophisticated IT applications with a variety of equipment types. For most airlines, electronic ticketing has become more prevalent than paper tickets. Therefore, with no paper documentation, the audit team would focus on testing the ticket and revenue systems in order to rely on those systems. Airlines may use batch processing systems, online systems, or minicomputers. The types of applications that the auditor may encounter in the airline industry include the following:

- Online information systems that may allow third-party access to the system
- Sales audit applications, including matching of passenger tickets lifted with tickets sold, testing of fare computations and any applicable commissions, and segregating and billing of interline transactions
- Frequent flyer mileage accumulation systems that interface with revenue and reservation systems to record earning, sales, and redemption of miles
- Inventory and maintenance accounting systems to control and segregate rotable and expendable parts and track maintenance costs incurred
- Revenue accounting applications used to determine earned revenue
- Payroll and benefit applications that account for numerous labor contract provisions that affect the determination of pay
- Fuel management systems that track fuel utilized and held as inventory at period end
- Fixed asset systems that track flight and ground assets and calculate depreciation expense
- Derivative instrument valuation and accounting systems

2.52 The auditor may consider matters such as

- the extent that information technology is used for significant accounting applications;
- the complexity of the institution's information technology, including whether outside service organizations are used;
- the organizational structure for information technology, including the extent that on-line terminals and networks are used;
- the physical security controls over computer equipment;
- controls over information technology (for example, program changes and access to data files), operations, and systems;
- the availability of data; and
- the use of information technology assisted audit techniques to increase the efficiency and effectiveness of performing procedures. (Using information technology assisted audit techniques may also provide the auditor with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible

for the auditor to analyze certain data or test specific control procedures without information technology assistance.)

Internal Auditors

2.53 Although not unique to the airline industry, an internal audit group may be a factor to be considered by the auditor in determining the nature, timing, and extent of auditing procedures to be performed. An internal audit function may affect an organization's internal control over financial reporting in two ways. First, the function usually increases the attention devoted to internal control. Second, to the extent the function is responsible for a continuing evaluation of internal control, it serves the important role of monitoring internal control. Independent auditors may be able to coordinate efforts with the internal audit organization and use their efforts to provide audit evidence.

Station Locations

2.54 Each station location is typically responsible for providing substantially all aspects of airline operations. Although most accounting functions for the stations are performed at a central location, stations located throughout an air carrier's route system are responsible for performing, in whole or in part, most of the following functions:

- Limited amounts of ticket sales
- Collection of proceeds from ticket sales and important ancillary charges such as change fees, baggage fees, and numerous others
- Control over passenger boarding and flight close out necessary to ensure accurate processing of electronic ticket usage
- Approval or control of local expenditures, including payroll, passenger food, landing fees, fuel, passenger refunds, and special expenses for delayed flights (primarily in international locations)
- In certain foreign locations, billing of and collection from local credit cards
- Certain aircraft maintenance activities
- Custody of inventory and fixed assets
- Collection of certain incidental revenues, such as in-flight sales and related charges

2.55 Control activities have various objectives and are applied at various organizational and data processing levels. The extent and degree of control activities may vary, primarily with the size of the stations. Adequate segregation of duties may not be possible at smaller stations.

2.56 As part of the audit, the independent auditor would consider the control activities in existence at the station locations. The auditor may want to obtain a copy of the standard procedures manual, which is typically available at the station, and become familiar with the procedures to be followed. As part of the audit, the auditor would evaluate the adequacy of controls at the station locations, as well as the home office's controls over station operations.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
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> When performing an integrated audit, refer to paragraphs .B10–.B16 of appendix B, "Special Topics," of Auditing Standard No. 5 for

discussion of considerations when an entity has multiple locations or business units.

Service Organizations[3]

2.57 An airline may utilize a service organization in various areas of their operations. When planning and performing an audit of an entity that uses a service organization to process transactions, transactions that affect the user organization's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the user organization. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. Specifically, it expands on how the user auditor applies AU-C section 315 and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit, refer to paragraphs .B17–.B27 of appendix B, of Auditing Standard No. 5 regarding the use of service organizations.
>
> Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), states that an auditor should obtain an understanding of each of the five components of the entity's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the entity and by service organizations whose services are part of the entity's information system.
>
> Paragraph .16 of AU section 324 states that the guidance in paragraphs 18 and 29–31 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding the auditor's consideration of the sufficiency of evidential matter to support a specific assessed level of control risk is applicable to user auditors considering evidential matter provided by a service auditor's report on controls placed in operation and tests of operating effectiveness.

2.58 Paragraphs .03–.05 of AU-C section 402 state that services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes, relevant to

[3] The AICPA Audit Guide, *Service Organizations: Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*, contains information for practitioners reporting on controls at a service organization that affect user entities' internal control over financial reporting. Also, the AICPA Audit Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*℠ summarizes the three service organization controls (SOC) reports℠ and provides detailed guidance on planning, performing, and reporting on SOC 2℠ engagements.

financial reporting. Although most controls at the service organization are likely to relate to financial reporting, other controls also may be relevant to the audit, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting of these services affect any of the following:

a. The classes of transactions in the user entity's operations that are significant to the user entity's financial statements

b. The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements

c. The related accounting records, supporting information, and specific accounts in the user entity's financial statements that are used to initiate, authorize, record, process, and report the user entity's transactions (This includes the correction of incorrect information and how information is transferred to the general ledger; the records may be in either manual or electronic form.)

d. How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements

e. The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures

f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments

2.59 The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

2.60 AU-C section 402 does not apply to services that are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker (that is, when the user entity retains responsibility for authorizing the transactions and maintaining the related accountability). In addition, AU-C section 402 does not apply to the audit of transactions arising from an entity that holds a proprietary financial interest in another entity, such as a partnership, corporation, or joint venture, when the partnership, corporation, or joint venture performs no processing on behalf of the entity.

2.61 Among other things, airlines can use service organizations for the following:

- Payroll and benefits processing
- IT system outsourcing
- Sales processing using organizations such as Bank Settlement Plan, International Airline Transport Association (IATA), and Airline Reporting Corporation

- Ticket processing and scanning
- Revenue accounting control and other financial systems

Risks Assessment and the Design of Further Audit Procedures

2.62 As discussed previously in paragraphs 2.11–.33, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Identifying and Assessing the Risks of Material Misstatement

2.63 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements;

b. relate the identified risks to what can go wrong at the relevant assertion level;

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

2.64 To provide a basis for designing and performing further audit procedures, paragraphs .26–.27 of AU-C section 315 state that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures.[4] For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements;

b. assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

c. relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and

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[4] This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

d. consider the likelihood misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

2.65 Paragraph .A108 of AU-C section 315 explains that the risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level (for example, through management override of internal control). Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

2.66 *Process of identifying risks of material misstatement.* Paragraph .A120 of AU-C section 315 explains that information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

Risks That Require Special Audit Consideration

2.67 Paragraphs .28–.29 of AU-C section 315 state that as part of the risk assessment described in paragraph .26 of AU-C section 315, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising professional judgement about which risks are significant risks, the auditor should consider at least

a. whether the risk is a risk of fraud;

b. whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;

c. the complexity of transactions;

d. whether the risk involves significant transactions with related parties;

e. the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

f. whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

2.68 If the auditor has determined that a significant risk exists, paragraph .30 of AU-C section 315 states that the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks. See paragraphs 2.79 and 2.83 for discussion over further audit procedures pertaining to significant risks.

2.69 In the airline industry, the following areas are often viewed as significant risks:

- Revenue accounting due to the estimates of revenue breakage and interline reserves
- Accounting for frequent flyer programs
- Fuel and currency hedging
- Regional airline capacity purchase agreements
- Impairment issues during economic and industry downturns including aircraft and related rotable inventory routes, slots and other identifiable intangible assets
- Significant employee benefit accruals including pensions and other postemployment benefits
- Liquidity considerations including the ability of the carrier to continue as a going concern

Designing and Performing Further Audit Procedures

2.70 AU-C section 330 addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements.

Overall Responses

2.71 Paragraph .05 of AU-C section 330 states that the auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. Paragraph .A1 of AU-C section 330 states that overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, incorporating additional elements of unpredictability in the selection of further audit procedures to be performed, or making general changes to the nature, timing, or extent of further audit procedures (for example, performing substantive procedures at period end instead of at an interim date or modifying the nature of audit procedures to obtain more persuasive audit evidence).

2.72 Paragraphs .A2–.A3 of AU-C section 330 go on to explain that the assessment of the risks of material misstatement at the financial statement level and, thereby, the auditor's overall responses are affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and, thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period-end. Deficiencies in the control environment, however, have the opposite effect (for example, the auditor may respond to an ineffective control environment by

- conducting more audit procedures as of the period-end rather than at an interim date,
- obtaining more extensive audit evidence from substantive procedures, and
- increasing the number of locations to be included in the audit scope).

2.73 Such considerations, therefore, have a significant bearing on the auditor's general approach (for example, an emphasis on substantive procedures [substantive approach] or an approach that uses tests of controls as well as substantive procedures [combined approach]).

Further Audit Procedures

2.74 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. Paragraph .06 of AU-C section 330 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and responsive to the assessed risks of material misstatement at the relevant assertion level.

2.75 In designing the further audit procedures to be performed, paragraph .07 of AU-C section 330 states that the auditor should

a. consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure, including

   i. the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and

   ii. whether the risk assessment takes account of relevant controls (the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures), and

b. obtain more persuasive audit evidence the higher the auditor's assessment of risk.

2.76 *Tests of controls.* In accordance with paragraph .08 of AU-C section 330, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if (*a*) the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures) or (*b*) when substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level. In accordance with paragraph .A21 of AU-C section 330, tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in a relevant assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

2.77 Paragraph .A22 of AU-C section 330 states that the testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented.

2.78 Paragraph .A23 of AU-C section 330 states that although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls.

2.79 *Timing of tests of controls over significant risks.* One or more significant risks normally arise on most audits.[5] Paragraph .15 of AU-C section 330 states that if the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period.

2.80 *Substantive procedures.* Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, in accordance with paragraph .18 of AU-C section 330.

2.81 Paragraph .21 of AU-C section 330 states that the auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as

- agreeing or reconciling the financial statements with the underlying accounting records and
- examining material journal entries and other adjustments made during the course of preparing the financial statements.

2.82 Paragraph .A57 of AU-C section 330 states that the nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

2.83 *Substantive procedures responsive to significant risks*. If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, paragraph .22 of AU-C section 330 states that the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

2.84 *Substantive analytical procedures.* AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures). It also addresses the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

2.85 As explained in paragraphs .A2–.A3 of AU-C section 520, analytical procedures include the consideration of comparisons of the entity's financial information with, for example, comparable information for prior periods, anticipated results of the entity (such as, budgets or forecasts) or expectations of the auditor, or similar industry information. Analytical procedures also include consideration of relationships, for example among elements of financial

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[5] According to paragraph .27 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), the auditor should treat those assessed risks of material misstatement due to fraud as significant risks. Paragraph .26 of AU-C section 240 states that there is a presumption that risks of fraud exist in revenue recognition. Paragraph .31 of AU-C section 240 states that the risk of management override of controls is present in all entities and is a risk of material misstatement due to fraud and thus, a significant risk. Thus, there are generally at least two significant risks in any financial statement audit.

information that would be expected to conform to a predictable pattern based on recent history of the entity and industry or between financial information and relevant nonfinancial information (such as, payroll costs to number of employees). When designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures, paragraph .05 of AU-C section 520 states that the auditor should

a. determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions;

b. evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation;

c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

2.86 Paragraphs .A13–.A14 of AU-C section 520 explain that different types of analytical procedures provide different levels of assurance. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. Paragraph .A8 of AU-C section 520 states that the effectiveness and efficiency of a substantive analytical procedure in addressing risks of material misstatement depends on, among other things, (*a*) the nature of the assertion, (*b*) the plausibility and predictability of the relationship, (*c*) the availability and reliability of the data used to develop the expectation, and (*d*) the precision of the expectation. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, paragraph .A19 of AU-C section 520 notes that the auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in per-forming the substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor may have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over nonfinancial information may often be tested in conjunction with other tests of controls.

2.87 Paragraph .08 of AU-C section 520 states that when substantive analytical procedures have been performed, the auditor should include in the audit document the following:

a. The expectation referred to in paragraph 2.85*c* and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation

b. Results of the comparison referred to in paragraph 2.85*d* of the recorded amounts, or ratios developed from recorded amounts, with the expectations

c. Any additional auditing procedures performed relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such additional procedures

2.88 Refer to exhibit 2-2 to this chapter, which sets forth example substantive audit procedures.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

2.89 Paragraph .28 of AU-C section 330 states the auditor should conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions in the financial statements.

Evaluation of Misstatements Identified During the Audit

2.90 Based on the results of audit procedures performed, the auditor may identify misstatements in accounts or notes to the financial statements. AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements. Paragraphs .05–.12 of AU-C section 450 address specific requirements the auditor should perform in relation to accumulation of identified misstatements, consideration of identified misstatements as the audit progresses, communication and correction of misstatements, evaluating the effect of uncorrected misstatements[6] and documentation.

2.91 The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are below the materiality threshold for the financial statements as a whole. For example, a loan made to a related party of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. Paragraph .A23 of AU-C section 450 provides circumstances that the auditor may consider relevant in determining whether misstatements are material.

2.92 AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), addresses the auditor's

[6] The Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SAB points out that some registrants do not consider the effects of prior year errors on current year financial statements that allow the entity to report unadjusted (and improper) assets and liabilities. The SAB also notes that an immaterial error on the balance sheet could be material on the income statement.

responsibility in forming an opinion on the financial statements based on the evaluation of the audit evidence obtained. The auditor's conclusion, required by AU-C section 700 takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with AU-C section 450.

Consideration of Fraud in a Financial Statement Audit[7]

2.93 AU-C section 240 addresses the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how AU-C sections 315 and 330 are to be applied regarding risks of material misstatement due to fraud.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> Paragraph .01 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules, Interim Standards*), states that when performing an integrated audit, the auditor should refer to paragraphs 14–15 of Auditing Standard No. 5 regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316.
>
> Paragraph 8 of Auditing Standard No. 13 states that the auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure. Paragraph 12 of Auditing Standard No. 13 states that the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

2.94 Although fraud is a broad legal concept, for the purposes of GAAS, the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. In accordance with paragraph .03 of AU-C section 240, two types of intentional misstatements are relevant to the audit: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Additionally, three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

Professional Skepticism

2.95 Consistent with paragraph .15 of AU-C section 200, paragraph .12 of AU-C section 240 states that the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

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[7] See footnote 5.

2.96 Paragraphs .A9–.A10 of AU-C section 240 state that maintaining professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance when relevant. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risk of material misstatement due to fraud because there may have been changes in circumstances.

2.97 When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), paragraph .14 of AU-C section 240 states that the auditor should further investigate the inconsistencies or unsatisfactory responses.

Discussion Among the Engagement Team

2.98 AU-C section 315 requires a discussion among the key engagement team members (see detailed discussion at paragraph 5.31). Paragraph .15 of AU-C section 240 states this discussion should include an exchange of ideas or brainstorming among the engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The discussion should occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity, and should, in particular, also address

a. known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;

b. the risk of management override of controls;

c. consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting;

d. the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud; and

e. how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Communication among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new facts during the audit.

2.99 Paragraph .A12 of AU-C section 240 states that discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team

- provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention during the audit.

2.100 In addition, paragraph .A13 of AU-C section 240 states the discussion may include a consideration of the following matters:

- Management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation
- Any unusual or unexplained changes in behavior or lifestyle of management or employees that have come to the attention of the engagement team
- Types of circumstances that, if encountered, might indicate the possibility of fraud
- How an element of unpredictability will be incorporated into the nature, timing, and extent of the audit procedures to be performed
- Audit procedures that might be selected to respond to the susceptibility of the entity's financial statements to material misstatement due to fraud and whether certain types of audit procedures are more effective than others
- Any allegations of fraud that have come to the auditor's attention

2.101 A number of factors may influence the extent of the discussion and how it may occur. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. Another factor in planning the discussions is whether to include specialists assigned to the audit team.

Fraud Risk Factors

2.102 Two types of fraud are relevant to the auditor's consideration, namely, fraudulent financial reporting and the misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur, which are incentives/pressures, opportunities, and attitudes/rationalizations.

2.103 Although fraud is a broad legal concept, for the purposes of GAAS, paragraph .03 of AU-C section 240 states that the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. Some of the following factors and conditions are present in entities in which specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditors might assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

2.104 Certain aspects of the airline industry can create a higher risk of the presence of fraud occurring at an airline. These items are discussed subsequently.

A. Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:
   - *a*. High degree of competition or market saturation, accompanied by declining margins
   - *b*. Significant declines in customer demand and increasing business failures in either the industry or overall economy
   - *c*. Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
2. Excessive pressure exists for management to meet the requirements or expectations of shareholders or third parties due to the following:
   - *a*. Profitability or trend level expectations of shareholders, organized labor, investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
     - i. Carriers with profitable or breakeven financial results may feel pressure to support their stock price for internal and external reasons including raising additional capital to fund operations.
   - *b*. Marginal ability to meet exchange listing requirements or debt repayment, debt covenant requirements, or other liquidity arrangements (such as credit card holdback ratios)
     - i. Tight or restrictive debt covenant calculations may provide incentive for fraudulent financial reporting.
3. Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:
   - *a*. Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow
     - i. Equity compensation (or other bonuses) typically represents a significant portion of executive compensation in the airline industry. Because of the poor performance of the airline sector as a group, management may focus on ways to achieve certain financial results through fraudulent

financial reporting to protect their own financial interests.

4. Adverse relationships between the entity and employees, including employees of organized work groups, that may have strained relationships with the airline, and with access to cash or other assets susceptible to theft, may motivate those employees to misappropriate those assets.

   a. Potential adverse relationships between the airline and employees with access to cash or other assets may exist due to known or anticipated future layoffs, benefit plan changes, or other labor related disputes.

B. Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

   a. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.

      i. Given the significant level of assumptions and estimates in the revenue area (primarily related to revenue breakage and frequent flyer programs) combined with the economic environment and poor financial results of certain carriers, an airline may try to inappropriately alter revenue recognition.

      ii. Subjective estimates are involved in establishing reserves and other contractual obligations (such as pensions) that may be prone to manipulation in order to achieve financial goals.

   b. Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.

      i. Significant operations in foreign jurisdictions, performed by employees with different cultural backgrounds and experiences may be more susceptible to fraud.

   c. Sales and disbursement transactions can be executed by multiple locations (although a leading practice is for a significant amount of centralization of these transactions). The more locations actively involved in sales or disbursement transactions can increase the risk of fraud, absent strong controls.

   d. When airlines have financial difficulties and are experiencing cash shortfalls, the auditors need to be aware of changes in payment timing of amounts due for transaction taxes or other government remittances because the consequences of not remitting these items timely can be severe.

e. Substantial reductions and changes in operations provide other opportunities given the unstable and complex nature of the airline industry.

2. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are large amounts of cash at multiple locations in the airlines network.

Considering the Results of the Analytical Procedures Performed in Planning the Audit

2.105 Paragraph .A8 of AU-C section 315 states that analytical procedures may enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. Due to the nature of the airline industry (typically characterized by a large number of individually small transactions) macro level analytical procedures do not tend to be the most effective at identification of where fraud may occur. However, a number of micro level analytical procedures may be available to help uncover unusual relationships that might be early indicators of fraud in the operations. Frequently, these are performed by the airline with the result available for the auditor to review and evaluate. They may include the following:

- Analysis of changes in revenues resulting from
  - — different mix of business and leisure customers
  - — decrease in average ticket prices
  - — changes in nonrefundable tickets
  - — reductions in aircraft, facilities, and personnel
- Market basis comparison to other competitors
- Yield analysis by flight, market, or segment level
- Analysis of route profitability over a historical period
- Analysis of other revenues by locations (for example, ticket change fees, baggage, excess baggage, or upgrade fees), to identify changes in the trend, which may indicate that issues with collection controls at the locations exist
- Analysis of reserves and other accounts involving significant management judgments and estimates
- Analysis of local expenses or spending to identify unusual trends
- Evaluation of subsequent revenue adjustments to identify problems in revenue processing that might be an indicator if a fraud issue

Identifying Risks That May Result in a Material Misstatement Due to Fraud[8]

2.106 As discussed previously, due to the nature of airlines, a number of accounts can be subjected to fraudulent activities including cash, accounts receivable, inventory and spare parts, breakage, frequent flyer accounting, and airline fleet assets. In addition, from a stand point of potential manipulation of financial results, a few of the areas that involve the most judgment and, therefore, present the greatest risk of manipulation are described as follows:

a. Revenue accounting transactions, including estimates of revenue breakage,[9] yield samples (for carriers using sampling revenue recognition method), accounting for interline transactions and for the sale of miles in frequent flyer or affinity programs. In each of these cases, the accounting involves significant assumptions and estimates that are generally based on historical experiences, but if not closely analyzed, can be difficult to discover through additional audit procedures. The auditor may want to be aware of changes in analysis or key assumptions in these significant estimates and conclude if, in the auditor's judgment, they are properly supported by the facts and circumstances.

b. Maintenance and engineering accounting. In the airline industry, three alternative methods exist for performing scheduled maintenance accounting (direct expensing method, built-in overhaul method, and deferral method). An airline using the deferral or built-in overhaul methods must make certain assumptions about the cost and timing of the scheduled maintenance events, which can affect the recorded results. In addition, an airline must apply the method selected consistently and cannot switch back and forth between methods. Additionally, consideration needs to be given to risk of transfer in proper accounting for power by the hour maintenance arrangements.

c. Subjective accrued liabilities, including the areas of employee compensation, and labor related agreements as well as environmental liabilities. These, and a number of other areas, are very subjective and difficult to audit; however, the auditor may need to determine that master cost components are properly accrued and that computation of liabilities is being done consistently.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

2.107 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period).

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[8] AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), requires the auditor to identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level for to classes of transactions, account balances, and disclosures. See paragraph .26 of AU-C section 315.

[9] *Revenue breakage* refers to amounts of revenue that are recognized on an estimated basis because regardless of the revenue recognition method used, certain lifts never get processed and other valuation differences (for example, statistical sampling differences) exist. (See chapter 3, "Marketing, Selling, and Providing Transportation," of this guide for more information.)

Therefore, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transaction, or assertions give rise to such risks. (See paragraph .26 of AU-C section 240.) Factors affecting revenue recognition in the airline industry include sale and valuation of miles in frequent flyer or affinity programs, breakage estimate assumptions, and interline accounting adjustments.

2.108 Airline revenues, for the most part, consist of a large number of individually small transactions, which can be difficult to manipulate due to the large population and small size of those transactions. However, the revenue recognition systems are very complex and, as a result, care is needed to help ensure that the revenue recognition process and IT programs are operating properly. In addition, revenue transactions, including estimates of revenue breakage, yield samples (for carriers using sampling revenue recognition method), accounting for interline transactions and for the sale of miles in frequent flyer or affinity programs, involve a large degree of judgment and, at times, estimation techniques must be applied by the airline. These estimates can be more easily manipulated to positively influence an airline's results and, as such, care is needed to audit these estimates to help ensure that they are prepared consistently and with proper historical data.

Key Estimates

2.109 There are a number of key estimates that are specific to the airline industry that could be considered. Key estimates in the airline industry affect the following accounts and transactions:

- Revenue transactions, including estimates of revenue breakage, rejected billings by other airlines, and yield samples (for carriers using sampling revenue recognition method)
- Accounting for the sale and issuance of miles in frequent flyer or affinity programs, and estimates of valuation, breakage and points usage
- Incremental cost of travel obligations for frequent flyer programs
- Deferred revenue related to the sale of miles to mileage program partners
- Accounts receivable allowances, including the effects of any counterparties operating under bankruptcy protection or financial difficulty
- Inventory allowances for obsolescence
- Assumptions regarding life of aircraft, residual value, and related parts
- Assumptions regarding impairments of long lived assets, including determining whether assets have indefinite or finite useful lives
- Derivative accounting and reporting transactions, including the application of hedge accounting
- Classification of airport and aircraft lease transactions as operating or capital leases and related accounting
- Assumptions related to pension and other benefit obligations, as well as to severance and retroactive wage accruals

- Property, casualty, workers' compensation, and other insurance loss reserves
- Assumptions regarding deferred tax valuation allowances and effective tax rates

2.110 AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), discusses the auditor responsibilities for assessing and documenting the estimates used by management.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

2.111 Paragraph .27 of AU-C section 240 states that the auditor should treat assessed risks of material misstatements due to fraud as significant risk and, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, and evaluate whether such controls have been suitable designed and implemented to mitigate the risks of fraud. The following are examples of programs and controls in the airline industry:

- Extensive systems of automated and manual internal controls over revenue and account receivables.
- The preparation of the financial statements and calculation of financial ratios are subject to multiple levels of management review.
- Electronic edit controls over the processing of revenue, payroll, and disbursement transactions exist to assess the value assigned to transactions and to verify many other aspects.
- Effective program change and access controls over the highly automated information technology environment.
- On a frequent basis, meetings are held with all departments to determine if the results of operations reported in internal financial reports are consistent with expectations.
- Airlines perform internal station audits to determine if internal controls are being followed and if assets subject to possible manipulation are being properly controlled.
- Airlines are independently monitored by the board of directors and audit committee.
- Airlines have controls that include monitoring assets by use of third party market pricing information, airline pricing guides, inventory values through purchasing, sales, and market research.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

2.112 In accordance with AU-C section 330, paragraphs .28–.29 of AU-C section 240 state that the auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. Accordingly, the auditor should

a. assign and supervise personnel, taking into account the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement;

b. evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings, or a bias that may create a material misstatement; and

c. incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures.

See paragraphs .A38–.A42 of AU-C section 240 for additional application guidance on overall responses to the assessed risks of material misstatement due to fraud.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

2.113 In accordance with AU-C section 300, paragraph .30 of AU-C section 240 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. (See paragraphs .A43–.A46 of AU-C section 240 for further application guidance.)

Audit Procedures Responsive to Risks Related to Management Override of Controls

2.114 Even if specific risks of material misstatement due to fraud are not identified by the auditor, paragraph .32 of AU-C section 240 states that a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to

a. test the appropriateness of journal entries recorded in the general ledger and other adjustments made in preparation of the financial statements, including entries posted directly to financial statement drafts,

b. review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud, and

c. evaluate, for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriate of assets.

2.115 *Other audit procedures.* Paragraph .33 of AU-C section 240 states that the auditor should determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to previously (that is, when specific additional risks of management override exist that are not covered as part of the procedures performed to address the requirements in paragraph .32 of AU-C section 240.

Analytical Procedures[10]

2.116 AU-C section 520 provides guidelines for the auditor to consider in the application of analytical procedures. AU-C section 315 addresses the use of analytical procedures in the planning stages of an audit. In addition, paragraph .06 of AU-C section 520 states the auditor should design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion.

2.117 Analytical procedures can provide useful audit evidence in the airline industry in both the operational and financial areas. This is particularly true for the larger carriers, for which statistical data is often readily available. Through the study of certain operating data and statistics, the auditor can evaluate revenue trends, aircraft efficiency, capacity utilization, labor productivity, unit costs and profitability, and return on investment.

2.118 Various units of measurement may be used in performing analytical procedures, such as cost per unit, ratios, or percentages. The data can be found in the airline's interim and annual financial statements and operating reports and, with additional details, in periodic reports filed with the DOT. Similar data for the industry and other airlines are available from the DOT, the ATA, and the IATA.

2.119 The available comparative cost data from independent public sources is a powerful tool for the auditor. Using data from such public sources as the DOT, ATA, and IATA, the auditor can perform tests, including those related to revenue, costs, and return on investment, of the airline. He or she can increase his or her confidence in the entity's financial results being reported by comparing them with those of other airlines.

2.120 Certain operating statistics are used universally within the airline industry. They provide an indication of the carrier's operations and are used to derive other barometers of performance. (See the glossary for definitions.) Among these are the following:

- Available seat miles
- Cost per available seat miles (CASM) and CASM, excluding fuel
- Revenue per available seat miles
- Revenue passenger miles (RPMs)
- Yield (both for revenue passenger and cargo ton mile)
- Available ton miles
- Average flight segment length
- Block-to-block aircraft hours (block hours)

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[10] The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures and includes a discussion of AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*); concepts and definitions; a series of questions and answers; and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis.

- Breakeven load factor
- Cargo ton miles (CTM)
- Load factor
- Revenue passengers
- Fuel gallons consumed
- Average aircraft fuel price per gallon
- Average aircraft utilization (hours per day)

2.121 These statistics basically indicate how much capacity the airline provides and how much is filled. However, relying on these statistics alone to assess a carrier's performance does not yield a meaningful evaluation. The complex interrelationship of the components of the carrier's operations would need to be considered when attempting to use statistics and financial information to analyze the operations of a carrier. For example, a change in available seat miles can result from the purchase of new equipment, a change in fleet utilization, schedule changes (resulting in a longer aircraft day or utilization period), or the reconfiguration of existing equipment by adding or removing seats. Additionally, an airline with shorter average flight stage length will generally have a higher yield to offset the higher level of variable costs that must be absorbed (for example, landing fees charged by airports which do not vary by length of flight). By keeping these relationships in mind, the auditor can use statistical data effectively.

2.122 In the analysis of operating expense variations, the auditor focuses primarily on two significant costs: salaries and wages, and fuel expenses. Because of the interaction of units of manpower or fuel and the price of the units, the most efficient way to examine these expenses is to use price and volume analysis. Such analysis simply seeks to explain the variation by breaking down the gross dollar amount into the change due to growth or decrease in units used (the volume component) and the increase or decrease in the price of such units (the price component). The change in certain operating statistics—for example, scheduled departures, block-to-block aircraft hours (the hours from the moment an aircraft first moves under its own power until it comes to rest at the next point of landing, including taxi time before takeoff and after landing), gallons of fuel consumed, or number of employees—will indicate the increase or decrease in volume or units used. The price component is more important and may be expressed as average price per gallon or average wage or salary per employee. By using price and volume analysis, the auditor can better isolate the causes of cost fluctuations and obtain more meaningful explanations.

2.123 The auditor can analyze other operating expenses by developing statistics from financial and nonfinancial operating data for the purpose of making historical comparisons. For example, the auditor can look at overall changes in operating expenses by relating total operating expenses to revenue miles flown, total available ton miles, or available seat miles. If current-year results deviate significantly from historical patterns, additional detailed analysis may be warranted. In that case, the auditor may look at the relationship of aircraft servicing expenses to the total number of ground personnel or the relationship of traffic servicing expense to the total number of personnel in that function.

2.124 In analyzing flight operations expense variations, a useful benchmark is the number of block hours per day for the aircraft because this measures how effectively the airline is using its available capacity. As block hours per day vary, so do revenues and expenses. Many costs are directly related to the length of time the aircraft is in revenue service. For example, the auditor may analyze the change in the following ratios between years:

- Flight crew salaries and expenses/total block hours
- Other flight personnel salaries and expenses/total block hours
- Fuel and oil expense/total block hours

2.125 These ratios can also be reviewed on a fleet-type basis for further refinement of variation explanations.

2.126 For other flight operation expenses, a more meaningful benchmark may be total hours flown because certain costs are incurred on that basis, regardless of whether the aircraft is in revenue service. Using this measure, the auditor can derive the following ratios:

- Aircraft rentals/total hours flown
- Flight equipment maintenance/total hours flown

2.127 The auditor can use other operating statistics to analyze other key expense items. He or she can divide landing fees (in total, by fleet type, or by station) by scheduled departures to obtain an average cost per landing. Or, the auditor may analyze agency commission expense by determining what percentage of agency sales it represents and comparing the result with commission rates. In short, most operating expenses can be analyzed effectively through the use of nonfinancial statistics and data.

2.128 In applying analytical procedures to revenues, the auditor would focus on an important statistic, which is the yield (the average revenue per unit of traffic carried in revenue service). It is usually calculated as average revenue per passenger mile, or cents per RPM. (For cargo, it is calculated as average revenue per cargo ton mile, or cents per CTM.)

2.129 Because many elements of an airline's operations can be reviewed analytically, this discussion is not all-inclusive. Although the analysis of the data will need to be supplemented by inquiries, observations, and other procedures, the auditor can audit a carrier's financial statements more effectively and efficiently by increasing the use of such data within the guidelines of AU-C section 520.

Concluding the Audit

2.130 At or near the end of audit fieldwork, the auditor may perform certain procedures before issuing his or her report. The procedures involved in completing the audit include the following:

- Performing analytical procedures in the overall review stage.
- Evaluating whether the financial statements are free of material misstatements. Procedures include the following:
  - — Evaluating uncorrected misstatements and concluding whether the accumulated misstatements cause the financial statements to be materially misstated (AU-C section 450)

  - Evaluating whether the accumulated results of audit procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit (AU-C section 240)
  - Considering the effect of undetected misstatements
  - Considering the possibility of management's bias
- Obtaining legal letters.
- Reviewing for subsequent events.
- Obtaining written management representations.
- Evaluating whether there is a substantial doubt about the airline's ability to continue as a going concern for a reasonable period of time.
- Preparing the auditor's reports.
- Communicating, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in the audit (AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* [AICPA, *Professional Standards*]).
- Communicating the auditor's views about qualitative aspects of the airline's significant accounting policies; significant difficulties encountered during the audit, uncorrected misstatements (other than those the auditor believes are trivial); disagreements with management; material, corrected misstatements; representations that the auditor is requesting of management; management's consultations with other accountants; significant issues discussed with management; and other significant findings or issues that the auditor believes are significant and relevant to those charged with governance (AU-C section 260, *The Auditor's Communication With Those Charged With Governance* [AICPA, *Professional Standards*]).

2.131 This section of the chapter addresses some of these procedures, which concern the following:

- Going concern considerations
- Considering subsequent events
- Obtaining written representations from management

Going Concern Considerations

2.132 AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), addresses the auditor's responsibility in an audit of financial statements with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. AU-C section 570 applies to all audits of financial statements, regardless of whether the financial statements are prepared in accordance with a general purpose or a special purpose framework. This guidance does not apply to an audit of financial statements based on the assumption of liquidation (for example, when [*a*] an entity is in the process of liquidation, [*b*] the owners have decided to commence dissolution or liquidation, or [*c*] legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable). The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at the time or have occurred prior to the date of the auditor's report. Paragraph .10 of AU-C section 570 states the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of such conditions or events. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited. The auditor should

- assess whether it is likely that the adverse effects would be mitigated by management's plans for a reasonable period of time;
- identify those elements of management's plans that are particularly significant to overcoming the adverse effects of the conditions or events and plan and perform procedures to obtain audit evidence about them, including, when applicable, considering the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets; and
- assess whether it is likely that such plans can be effectively implemented.

2.133 The auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of airlines:

a. Recurring operating losses

b. Indications of strained liquidity, such as an inability to meet debt, lease, or pension payments or the refinancing of current obligations with longer-term obligations

c. Failure to meet contractual requirements (for example, debt covenants)

d. Credit card holdback agreements and their potential effect on liquidity

e. Inability to cover current operating needs through cash provided by operations

f. Actual or planned bankruptcy proceedings

g. Rising operating costs, such as fuel and insurance

h. Occurrence, or risk of occurrence, of employee strikes or labor-related disruptions

i. Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe and unsound practices

j. Rating agency downgrade

k. Significant pension plan funding requirements

l. Major disasters such as crashes or terrorist acts *m.* Availability of insurance coverages, such as war-risk insurance, either through the government or on commercially reasonable terms

n. Continuing loss of market share to competitors, such as low-cost carriers

o. Service disruptions due to war, the threat of war, or severe contagious diseases

p. Difficulty in obtaining additional financing due to (i) deteriorating credit ratings, (ii) reduction in assets available for secured borrowings (including reduction in Section 1110 assets), and (iii) credit market constraints

2.134 Paragraph .A1 of AU-C section 570 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

2.135 Paragraph .22 of AU-C section 570 states if the auditor believes, before consideration of management's plans pursuant as discussed previously (paragraph 2.105), there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, the auditor should document all of the following:

a. The conditions or events that led the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.

c. The audit procedures performed to evaluate the significant elements of management's plans and evidence obtained.

d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the auditor's conclusion as to the need for, and, if applicable, the adequacy of, disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt.

e. The auditor's conclusion with respect to the effects on the auditor's report.

Considering Subsequent Events

2.136 There is a period after the balance-sheet date with which the auditor must be concerned in completing various phases of his or her audit. This period is known as the *subsequent period* and is considered to extend to the date of the auditor's report. For a discussion, see AU-C section 560, *Subsequent Events and*

Subsequently Discovered Facts (AICPA, *Professional Standards*). Subsequent events consist of events or transactions that

a. provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements.

b. provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading.

2.137 The size or other significance and timing of subsequent events will affect whether they would be reported in the financial statements or the notes thereto. The following list includes examples of subsequent events that an airline may experience:

- The filing or settlement of a lawsuit
- The issuance or defeasance of bonds or other debt instruments
- Renegotiating or obtaining additional credit facilities
- A renegotiated labor contract with the entity's employees
- Entering into new joint venture agreements with alliance partners
- Entering into a new capacity purchase agreement with a regional airline
- Renegotiating new or significant leases
- Entering into or existing bankruptcy proceedings
- Changes in tax law or other regulations

2.138 Subsequent events may be discovered as a result of audit procedures applied to specific financial statement elements for other audit objectives or through cutoff testing and assessment of asset and liability valuations. In addition to standard audit procedures to identify subsequent events, procedures that are unique or significant in an airline audit may include the following:

- Reading minutes of the board of directors and other committee meetings held since the financial statement date
- For public airlines, reviewing the description in the management's discussion and analysis of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations for items that represent subsequent events
- Reviewing new alliance agreements
- Reviewing operating results to ensure that segment information continues to be appropriate

Considerations for Audits Performed in Accordance With PCAOB Standards

When performing an integrated audit, refer to paragraphs 93–98 of Auditing Standard No. 5, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

Obtaining Written Representations From Management

2.139 AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), addresses the auditor's responsibility to obtain written representations from management and, when appropriate, those charges with governance in and audit of financial statements. AU-C section 580 includes a list of matters to which specific representations should relate, as well as an illustrative management representation letter and an appendix containing additional representations that may be appropriate to include in a management representation letter.

Written Representations as Audit Evidence

2.140 According to paragraphs .03–.04 of AU-C section 580, written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, obtaining reliable written representations does not affect the nature or extent of other audit procedures that the auditor applies to obtain audit evidence about the fulfillment of management's responsibilities or about specific assertions.

Management From Whom Written Representations Are Requested

2.141 As explained in paragraph .A2 of AU-C section 580, written representations are requested from those with overall responsibility for financial and operating matters whom the auditor believes are responsible for, and knowledgeable about, directly or through others in the organization, the matters covered by the representations, including the preparation and fair presentation of the financial statements. As such, in accordance with paragraph .09 of AU-C section 580, the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

2.142 Paragraph .A2 of AU-C section 580 further states that those individuals with overall responsibility may vary depending on the governance structure of the entity; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, also are responsible for the preparation and fair presentation of the financial statements.

Written Representations About Management's Responsibilities and Other Written Representations

2.143 Paragraphs .10–.18 of AU-C section 580 discuss matters the auditor should request management to provide written representation about such as preparation and fair presentation of the financial statements, information provided and completeness of transactions, fraud, laws and regulations, uncorrected misstatements,[11,12] litigation an claims, estimates, related party transactions, and subsequent events. If, in addition to such required representations and those addressed in other AU-C sections,[13] the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, paragraph .19 of AU-C section 580 states that the auditor should request such other written representations.

Considerations for Audits Performed in Accordance With PCAOB Standards

Paragraph .05 of AU section 333, *Management Representations* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 75–77 of Auditing Standard No. 5 for additional required written representations to be obtained from management.

2.144 Paragraph .19 of AU-C section 580 states that other AU-C sections require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor should request such other written representations. Consequently, depending on the circumstances and professional judgment, the auditor of an airline may want to consider obtaining representations from management that include the following:

- Management has made the appropriate estimates in revenue related to breakage, yields (for carriers using the sampling method of revenue recognition), and interline billings.
- Management has made the appropriate estimates related to frequent flyer programs including breakage estimates, and valuation of incremental cost and fair value of mileage sold to affinity partners.
- Management has disclosed appropriate segment information.
- Management has made the appropriate assessment of the value of intangible assets such as goodwill, routes, gates, slots and airport operating rights, and recorded impairment charges where necessary.
- Management has made the appropriate assessment of whether triggering events have occurred requiring an impairment analysis of identifiable intangible assets.

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[11] Auditing Standard No. 14, *Evaluating Audit Results* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), indicates that a misstatement can arise from error or fraud and also discusses the auditor's responsibilities for evaluating accumulated misstatements.

[12] Paragraph .11 of Auditing Standard No. 14 states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representations letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated.

[13] Exhibit D, "List of AU-C Sections Containing Requirements for Written Representations," of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), lists other AU-C sections containing subject matter-specific requirements for written representations. The specific requirements for written representations of other AU-C sections do not limit the application of this section.

- Management has made provisions, where appropriate, on the value of aircraft and related spare parts, materials, and supplies.
- Management's estimate of useful lives and residual values of aircraft are appropriate considering industry conditions and plans to operate such aircraft.
- Management has identified and recorded appropriate provisions for uncollectible receivables.
- Management's determination of assumptions utilized in pension and other employee retirement benefits are applied consistently and are reasonable based on industry economic conditions.
- Management has made appropriate assessment of the carrying value of future income tax assets.
- Management is responsible for compliance with laws, regulations, and provisions of contracts applicable to the entity (for example, tax or debt limits and debt covenants).
- Management's expectations regarding debt covenant compliance and the operating and cash flow plans utilized in concluding on ability of the entity to continue as a going concern or assess the realizability of intangible assets.

2.145 Other entity-specific representations may be needed, depending on the particular facts and circumstances.

Considerations for Audits Performed in Accordance With PCAOB Standards

When performing an integrated audit, refer to paragraphs 75–77 of Auditing Standard No. 5 for additional required written representations to be obtained from management.

Exhibits

2.146 The following exhibits are critical components of this chapter and provide the auditor with guidance on identification of significant accounts and relevant assertions including significant processes and key controls that support those accounts that are unique to the airline industry. These exhibits are not all-inclusive of the significant accounts or significant processes that the auditor would expect to see at an airline. Each of these exhibits is discussed further.

PCAOB auditing standards use the following categories of assertions: completeness, existence/occurrence, valuation/allocation, rights and obligations, presentation and disclosure. The same categories of assertions are used in the following exhibits. AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), of AICPA *Professional Standards* recategorizes assertions by classes of transactions, account balances, and presentation and disclosure. Please refer to the "Assessment of Risks of Material Misstatement at the Assertion Level" section of this chapter for more information. Paragraph .16 of AU section 326 provides, however, that the auditor may use the relevant assertions as they are described [in this AU section] or may express them differently provided aspects described [in this AU section] have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. Therefore, presentation of assertions in the following exhibits is believed to be consistent with both the PCAOB Auditing Standards and the AICPA *Professional Standards*.

Exhibit 2-1

Significant Accounts and Controls

This exhibit is primarily intended for auditors performing audits of internal control over financial reporting in accordance with Auditing Standard No. 5. However, auditors conducting audits of financial statements in accordance with the AICPA *Professional Standards* may also find this exhibit helpful because it provides examples of controls over certain processes.

Paragraph 21 of Auditing Standard No. 5 provides that the auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the entity's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

This exhibit does not address entity-level controls because they are not airline specific. Airlines are generally centralized and typically have strong entity-level controls, such as strong budget to actual monitoring that may need to be considered in an internal control audit.

This exhibit addresses accounts that are considered significant to an airline and that are unique to the airline industry. Accordingly, certain financial statement accounts which may be material to an airline (such as cash and investments) are not included herein because the controls related to these accounts are not unique to the airline industry.

Controls supporting the *rights and obligations* and *presentation and disclosure* assertions are not identified in this exhibit because such controls are typically part of the financial statement close process, which is not considered unique to the airline industry.

This exhibit includes key controls for each of the identified significant processes and indicates which financial statement assertion is addressed by each control. Although this exhibit may describe certain controls as manual and others as automatic, it is *not* intended to be prescriptive in that respect. For example, if a control is listed as a manual control, it does not mean it should be manual. That is, the same control can be performed manually in one entity whereas it may be automated in another. The auditors would determine which controls to test based on specific facts and circumstances.

2.1.1 Example Significant Accounts and Processes Matrix

Exhibit Reference	***Example Significant Processes***	***Transaction Types***	*Accounts Receivable, Trade*	*Inventories*	*Inventory Reserves and Related Income Statement Accounts*	*Prepaid Expenses, Deferred Charges, and Other Assets*	*Investments, including Investments in Affiliates*	*Long-Term Receivables, Noncurrent Deposits, and Other Long-Term Financial Assets*	*Property, Plant and Equipment, and Related Income Statement Accounts*	*Intangibles, including Goodwill and Related Amortization*	*Accounts Payable, Trade*	*Provisions, Accrued and Other Liabilities, Deferred Income*	*Long-Term Debt, Leases, and Related Income Statement Accounts*	*Revenue / Sales*	*Operating Expenses*	*Finance Expenses*
2.1.2	Agency, Entity, and Station Sales	Routine	x									x		x		
2.1.3	Cargo Revenue Recognition and Billing Process	Routine	x									x		x		
2.1.4	Frequent Flier Liability and Deferred Revenue	Routine										x		x		
2.1.5	Fuel Purchasing, Usage, and Inventory	Routine		x		x					x				x	
2.1.6	Interline Accounting	Routine		x		x					x			x	x	

(continued)

Exhibit Reference	***Example Significant Processes***	***Transaction Types***	*Accounts Receivable, Trade*	*Inventories*	*Inventory Reserves and Related Income Statement Accounts*	*Prepaid Expenses, Deferred Charges, and Other Assets*	*Investments, including Investments in Affiliates*	*Long-Term Receivables, Noncurrent Deposits, and Other Long-Term Financial Assets*	*Property, Plant and Equipment, and Related Income Statement Accounts*	*Intangibles, including Goodwill and Related Amortization*	*Accounts Payable, Trade*	*Provisions, Accrued and Other Liabilities, Deferred Income*	*Long-Term Debt, Leases, and Related Income Statement Accounts*	*Revenue/ Sales*	*Operating Expenses*	*Finance Expenses*
2.1.7	Investigation of Unmatched Usage	Routine												x		
2.1.8	Lift Process	Routine												x		
2.1.9	Refunds and Exchanges	Routine	x									x		x		
2.1.10	Revenue Recognition/Sales Use Match	Routine	x									x		x		
2.1.11	Air Traffic Liability and Deferred Revenue	Non-routine										x		x		
2.1.12	Aircraft Leases and Related Interest	Non-routine							x				x			x
2.1.13	Airport Facility Financing and Related Operating Lease Accounting	Non-routine							x			x	x			x

Exhibit Reference	***Example Significant Processes***	***Transaction Types***	*Accounts Receivable, Trade*	*Inventories*	*Inventory Reserves and Related Income Statement Accounts*	*Prepaid Expenses, Deferred Charges, and Other Assets*	*Investments, including Investments in Affiliates*	*Long-Term Receivables, Noncurrent Deposits, and Other Long-Term Financial Assets*	*Property, Plant and Equipment, and Related Income Statement Accounts*	*Intangibles, including Goodwill and Related Amortization*	*Accounts Payable, Trade*	*Provisions, Accrued and Other Liabilities, Deferred Income*	*Long-Term Debt, Leases, and Related Income Statement Accounts*	*Revenue/ Sales*	*Operating Expenses*	*Finance Expenses*
2.1.14	Assess Assets for Impairment	Estimation					x	x	x	x						
2.1.15	Capacity Purchase Agreement	Non-routine									x				x	
2.1.16	Estimate Excess and Obsolete Inventory Reserves	Estimation			x											
2.1.17	Revenue Breakage	Estimation										x		x		
2.1.18	Route Impairment	Estimation								x						
2.1.19	Payroll	Routine													x	

2.1.2

Process: Agency, Entity, and Station Sales

Transaction Type: Routine

Example Significant Accounts Affected:

Accounts Receivable, Trade

Provisions, Accrued and Other Liabilities, Deferred Income

Revenue/Sales

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	All sales (agency and entity) go through clearing accounts that are reconciled monthly.	☑		
2	Sales clearing account agings are reviewed to ensure that all items are resolved timely.	☑		
3	Sales reports that have not been actualized (that is, finalized) are included in monthly accrual for fare, various taxes, and commission.	☑		
4	Accounts receivable aging/subledger is reviewed and reconciled to the general ledger.	☑		
5	Late or missing sales reports, or both, are tracked and followed up timely.	☑		
6	Sale is matched to a payment voucher (credit card/cash).		☑	
7	Auditors validate other airline billing amounts (on a ticket/coupon level) using industry standard pricing.			☑
8	Analyst verifies and management reviews all accruals for unprocessed sales.			☑
9	Management analyzes regression analysis and other indicators/analyses for consideration of adjusting the breakage rate.			☑
10	Management reassesses the breakage rate assumptions and methodology.			☑
11	Internal auditors perform audits of agency transactions for commission, taxes, and fare discrepancies.			☑

2.1.3

Process: Cargo Revenue Recognition and Billing

Transaction Type: Routine

Example Significant Accounts Affected:

Accounts Receivable, Trade

Provisions, Accrued and Other Liabilities, Deferred Income

Revenue/Sales

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	A monthly analysis of cargo revenue is performed by Cargo Accounting department. Unusual variances are investigated and followed up timely.	☑	☑	☑
2	Account reconciliations are performed on a monthly basis, with significant variations investigated and followed up timely.	☑	☑	
3	Cargo Accounting department performs daily audits to identify data entry errors.	☑	☑	☑
4	Pricing is automated; sales not meeting certain parameters are investigated and followed up timely.			☑
5	Shipment manifests are generated automatically by the cargo system, and all shipments have manifests.		☑	
6	Weekly low and high yield reports are reviewed to identify systematic rating errors.			☑

2.1.4

	Process: Frequent Flier Liability and Deferred Revenue	**Example Significant Accounts Affected:** Provisions, Accrued and Other Liabilities, Deferred Income		
	Transaction Type: Routine	Revenue/Sales		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Actual to budget variance analysis is performed monthly, with differences investigated and followed up timely.			☑
2	Account reconciliations are performed on a monthly basis, with significant variations investigated and followed up timely.	☑	☑	
3	Assumptions used in calculating frequent flier deferred revenue are regularly reviewed and updated by appropriate personnel.			☑
4	Estimated reward redemptions are based upon historical trends and other third party statistical analyses.			☑
5	Miles per the system are regularly confirmed with frequent flier partners.	☑	☑	
6	Monthly frequent flier journal entries are reviewed and approved by appropriate personnel prior to posting.	☑	☑	
7	System automatically calculates deferred revenue based on mileage and rates in the system.			☑
8	The analytics and survey presentation (estimate) is prepared by an analyst and is reviewed and approved by appropriate revenue accounting personnel monthly. (Lift bases only)		☑	
9	The earning, purchasing, and redemption of mileage are automatically tracked by the system.	☑	☑	
10	Variances between the flight segments flown and recorded are reviewed weekly, with significant differences investigated and followed up timely.	☑		

2.1.5

Process: Fuel Purchasing, Usage, and Inventory

Transaction Type: Routine

Example Significant Accounts Affected:
Accounts Payable, Trade
Inventories
Prepaid Expenses, Deferred Charges and Other Assets
Operating Expenses

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Account reconciliations are performed on a monthly basis, with significant variations investigated and followed up timely.	☑	☑	
2	Accounts payable aging/subledger is reviewed and reconciled to the general ledger.	☑		
3	Bank reconciliations are prepared and reviewed timely.		☑	
4	Cost per gallon used in account reconciliations is reviewed for reasonableness.			☑
5	Fuel access database checks invoice total to expected total based on quantity as computed via price list, taxes, and fees.			☑
6	Fuel accounting personnel balance fuel quantities per the system to into-plane amounts on a daily and monthly basis.	☑	☑	
7	Fuel accounting reconciles prepayments and application of invoices to supplier statements.	☑	☑	
8	Fuel management system automatically performs various checks on input data (receipt to aircraft or station) including flight, aircraft data validity, duplicate receipt control, and inventory control.		☑	
9	Monthly analysis of total cost per gallon of purchased gallons (calculated using unit price, taxes, and miscellaneous fees) is computed and compared to weighted average cost per gallon.			☑
10	Monthly fuel accrual journal entries are reviewed by the fuel manager for completeness and accuracy.	☑		☑
11	Two-way match is performed between the purchase order created at fuel receipt and invoice received.	☑	☑	

2.1.6

Process: Interline Accounting

Transaction Type: Routine

Example Significant Accounts Affected:

Operating Expenses

Provisions, Accrued and Other Liabilities, Deferred Income

Revenue/Sales

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Account reconciliations are performed on a monthly basis, with significant variations investigated and followed up timely.	☑	☑	
2	Auditors validate other airline billing amounts (on a ticket/coupon level) using industry standard pricing.			☑
3	Billing invoices are reconciled to the clearinghouse settlements; significant fluctuations are investigated prior to posting to the general ledger.		☑	☑
4	Coupons are prorated based on industry standards.			☑
5	Journal entries for interline payables are prepared and reviewed by a manager/supervisor prior to posting to the general ledger.	☑	☑	☑
6	Monthly average coupon values billed to other airlines is reviewed for reasonableness by appropriate personnel.	☑		☑
7	Open coupons are regularly monitored to ensure that they are not included in current month's billing, but processed by following month-end.	☑	☑	
8	Sales information is shared between airlines, allowing other airline coupons to be automatically priced.			☑
9	The analytics and survey presentation (estimate) is prepared by an analyst and is reviewed and approved monthly by appropriate revenue accounting personnel. (Lift bases only)	☑	☑	

2.1.7

	Process: Investigation of Unmatched Usage **Transaction Type:** Routine	**Example Significant Accounts Affected:** Revenue/Sales Provisions, Accrued and Other Liabilities, Deferred Income		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Analyst verifies and management reviews revenue adjustments from the unearned revenue reconciliation.	☑	☑	☑
2	Management reviews revenue adjustments from monthly revenue close variance analysis.	☑	☑	☑
3	Management reviews unmatched lifts valuation through investigation of the monthly revenue close variance analysis and average pricing statistics.	☑	☑	☑
4	Management reviews unmatched usage lifts reports that are subsequently written off and investigates any unusual items.	☑	☑	☑

2.1.8

Process: Lift Process

Transaction Type: Routine

Example Significant Accounts Affected:

Revenue/Sales

Provisions, Accrued and Other Liabilities, Deferred Income

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	A third-party statistician validates yields monthly. (Lift bases only)			☑
2	Analyst reconciles and management review of unearned revenue reconciliation.	☑	☑	☑
3	Analyst reviews the system-generated Duplicate Usage (Lift) Report for duplicated lifts processed.		☑	
4	Analyst reviews the system-generated Potential Fraud Report for fraudulent tickets.		☑	
5	Billing invoices are reconciled to the clearinghouse settlements; significant fluctuations are investigated prior to posting to the general ledger.	☑		☑
6	Management preparation of lift accrual for unprocessed lifts.	☑		☑
7	Management regularly reviews lift yields.	☑		☑
8	Management reviews revenue adjustments from monthly revenue close variance analysis.	☑	☑	☑
9	Management reviews missing lifts by comparing paper and e-ticket lifts to information recorded at the flight level.	☑		
10	System prices lifted coupons of other airline paper and suspends unpriced lifts for manual pricing.			☑

2.1.9

	Process: Refunds and Exchanges **Transaction Type:** Routine	**Example Significant Accounts Affected:** Accounts Receivable, Trade Provisions, Accrued and Other Liabilities, Deferred Income Revenue/Sales		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Each month, the Accounting Controls group reconciles clearing accounts to various source documents.	☑	☑	☑
2	High value refunds require escalating levels of management approval.	☑	☑	☑
3	Journal entries are prepared by an analyst and are reviewed by the manager prior to posting to the general ledger.	☑	☑	☑
4	Quality audits are performed weekly to review transactions for clerical accuracy and adherence to policies.	☑	☑	☑
5	System feature where refunds greater than a specified amount have to be approved by a manager by entering a password.	☑	☑	☑
6	System identifies tickets refunded that are duplicates or that are in excess of the original ticket amount and produces a response that is investigated and resolved timely.		☑	☑

2.1.10

	Process: Revenue Recognition/Sales Use Match **Transaction Type:** Routine	**Example Significant Accounts Affected:** Accounts Receivable, Trade Provisions, Accrued and Other Liabilities, Deferred Income Revenue/Sales		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	A third-party statistician validates yields monthly. (Lift bases only)			☑
2	Account reconciliations are performed on a monthly basis, with significant variations investigated and followed up timely.	☑	☑	☑
3	Analyst verifies, and management reviews all accruals for unprocessed sales.			☑
4	Billing invoices are reconciled to the clearinghouse settlements; significant fluctuations are investigated prior to posting to the general ledger.		☑	☑
5	Internal auditors validate other airline billing amounts (on a ticket/coupon level) using industry standard pricing.			☑
6	Journal entries are prepared by an analyst and are reviewed by the manager prior to posting to the general ledger.	☑	☑	
7	Quality auditors validate prorated ticket segments, which have been previously prorated using an industry standard methodology.			☑
8	Previously prorated sales records provide the basis for the value assigned per lift.			☑
9	Sales use match department retrieves ticket image and audits the suspected unreported sale using a number of internal resources in order to eliminate erroneous exceptions.		☑	☑
10	The analytics and survey presentation (estimate) is prepared by an analyst and is reviewed and approved by appropriate revenue accounting personnel monthly. (Lift bases only)	☑	☑	☑
11	Variances between the flight segments flown and recorded are reviewed weekly and investigated as necessary.	☑	☑	☑

2.1.11

	Process: Air Traffic Liability and Deferred Revenue	**Example Significant Accounts Affected:**		
	Transaction Type: Nonroutine	Provisions, Accrued and Other Liabilities, Deferred Income		
		Revenue/Sales		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	A third-party statistician validates yields monthly. (Lift bases only)			☑
2	Account is reviewed by appropriate personnel during close, and missing information is followed up timely.	☑		
3	Analyst reconciles and management reviews unearned revenue reconciliation.	☑	☑	☑
4	Analyst verifies and management reviews revenue adjustments from the unearned revenue reconciliation.	☑	☑	☑
5	Analyst verifies, and management reviews all accruals for unprocessed sales.	☑		☑
6	Appropriate personnel provide input into the assumptions.			☑
7	Assumptions used to calculate revenue breakage are reviewed and reassessed periodically.			☑
8	Billing invoices are reconciled to the clearinghouse settlements; significant fluctuations are investigated prior to posting to the general ledger.		☑	☑
9	Calculation process is reviewed by senior management.			☑
10	Consistent and timely reviews are performed by appropriate personnel, with additional analyses performed during extraordinary business events.			☑
11	Internal auditors validate other airline billing amounts (on a ticket/coupon level) using industry standard pricing.			☑
12	Journal entries are compared to prior month and year to review for reasonableness of missing or additional entries.			☑
13	Management analyzes regression analysis and other indicators/analyses for consideration of adjusting the breakage rate.			☑
14	Management reassesses the breakage rate assumptions and methodology.			☑
15	Management reviews assumptions supporting the liability.			☑

2.1.12

	Process: Aircraft Leases and Related Interest **Transaction Type:** Nonroutine	**Example Significant Accounts Affected:** Property, Plant and Equipment, and Related Income Statement Accounts Long-Term Debt, Leases, and Related Income Statement Accounts Finance Expenses		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Asset Accounting prepares monthly summary spreadsheets which are reviewed by Fleet Transactions and Corporate Finance for accuracy and completeness.		☑	☑
2	Asset Accounting validates that the actual lease payment(s) each month agrees to what is loaded in the lease database.	☑		☑
3	Asset listings are generated as support for the net book value of the asset being sold.	☑		☑
4	Budget/forecast to actual comparisons are performed monthly for rent expense, capital lease depreciation, and interest expense.	☑		☑
5	Corporate Finance agrees the actual lease payment(s) each month to the scheduled payment per the lease agreement.	☑		☑
6	Lease accountant calculates the rent expense and interest expense of a new or renegotiated lease for budget purposes and compares it to the expense calculated by the database.		☑	☑
7	Lease expense (rent expense, interest on capital leases, amortization of deferred items) is calculated by the lease database and reviewed monthly for reasonableness and for any unusual items.	☑		☑
8	Maintenance and storage cost reserve reconciliations are reviewed quarterly. The status (remaining balance and reserve adjustments) of previous exit cost accruals are prepared for senior management quarterly.	☑		☑

Process: Aircraft Leases and Related Interest

Transaction Type: Nonroutine

Example Significant Accounts Affected:
Property, Plant and Equipment, and Related Income Statement Accounts

Long-Term Debt, Leases, and Related Income Statement Accounts

Finance Expenses

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
9	Monthly depreciation of capital lease assets and leasehold improvements is calculated by the system and reviewed and reconciled to the general ledger every month.	☑		☑
10	Short-term and long-term reclasses are calculated by the lease database and reviewed by the lease accountant each month.			☑
11	The lease accountant reviews all of the account reconciliations prepared by the database and reconciles the database reconciliations to the general ledger.	☑		☑
12	The manager of Asset Accounting reviews the accounting on sale-leasebacks based on current accounting literature.	☑		☑
13	The manager of Asset Accounting reviews the policy for aircraft depreciable lives and estimated residual values annually based on discussions with appropriate personnel in Fleet Planning and Fleet Transactions.	☑		☑

2.1.13

	Process: Airport Facility Financing and Related Operating Lease Accounting **Transaction Type:** Nonroutine	**Example Significant Accounts Affected:** Property, Plant and Equipment, and Related Income Statement Accounts Provisions, Accrued and Other Liabilities, Deferred Income Long-Term Debt, Leases, and Related Income Statement Accounts Finance Expenses		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Accounting performs analysis of rent leveling (that is, current balance less remaining payments divided by the number of periods should equal period rent expense).	☑	☑	
2	Accounting verifies timing and amounts of monthly payments for interest recorded against the accrued interest payable account spreadsheet/subledger and the bond obligation account spreadsheet/subledger.	☑		☑
3	All deals added and removed are reviewed by the relevant manager.	☑	☑	
4	Airport and Bond Accounting review activity in bond reserve and construction fund bank account statements and reconciles general ledger balances to bank statements.	☑	☑	
5	Asset and Bond Accounting verifies that the entries recording the bond issuance (along with payment/deduction of related fees) match the bond documents.	☑		
6	Asset and Bond Accounting verify timing and amounts of payments for bond principal (on-balance sheet) and interest (off-balance sheet) recorded in system against the scheduled payments in the bond obligations rollforward and the bond documents.	☑	☑	

	Process: Airport Facility Financing and Related Operating Lease Accounting **Transaction Type:** Nonroutine	**Example Significant Accounts Affected:** Property, Plant and Equipment, and Related Income Statement Accounts Provisions, Accrued and Other Liabilities, Deferred Income Long-Term Debt, Leases, and Related Income Statement Accounts Finance Expenses		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
7	Bond accounts are reconciled to the general ledger and are reviewed and approved by appropriate Project and Bond Accounting personnel.	☑	☑	
8	Bond rollforward spreadsheets are prepared and reviewed by appropriate personnel to verify that all bond issuances and redemptions have been accounted for.	☑		
9	Explanations of all significant bond account variances of actual to plan are prepared and reviewed by the controller as part of the monthly close meeting.	☑		☑

2.1.14

Process: Assess Assets for Impairment

Transaction Type: Estimation

Example Significant Accounts Affected:

Investments, including Investments in Affiliates

Intangibles, including Goodwill and Related Amortization

Long-Term Receivables, Noncurrent Deposits, and Other Long-Term Financial Assets

Property, Plant and Equipment, and Related Income Statement Accounts

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	A monthly summary of aircraft ownership is reviewed by appropriate personnel in Corporate Accounting and Fleet Management.	☑		☑
2	A second asset listing is generated after the writedown has been recorded, if necessary. Using the second asset listing, appropriate personnel review the accounting entries and any adjustments to the remaining life and residual value.			☑
3	Assumptions for impairment estimate are reviewed.			☑
4	Appropriate personnel review impairment tests to verify the value of recorded intangibles in accordance with client's accounting policies or applicable financial reporting framework.	☑		☑
5	Fleet plan changes are reviewed quarterly for criteria leading to possible impairment analysis (that is, temporary/permanent groundings).	☑		
6	Intangible asset impairment analysis (including annual route impairment and modifications to fleet plans) is prepared and reviewed in accordance with client's accounting policies or applicable financial reporting framework.	☑		☑
7	Management reviews specialists' valuation of assets.			☑

	Process: Assess Assets for Impairment Transaction Type: Estimation	Example Significant Accounts Affected: Investments, including Investments in Affiliates Intangibles, including Goodwill and Related Amortization Long-Term Receivables, Noncurrent Deposits, and Other Long-Term Financial Assets Property, Plant and Equipment, and Related Income Statement Accounts		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
8	Recorded assets are reviewed for impairment in accordance with client's accounting policies or applicable financial reporting framework.	☑		
9	Supporting calculations and analyses are reviewed.			☑

2.1.15

	Process: Capacity Purchase Agreement	**Example Significant Accounts Affected:** Revenue, Accounts Payable, Trade		
	Transaction Type: Nonroutine	Operating Expenses		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Allocation of costs is checked (pass-thru and non-pass-thru); block hours and departure statistics are validated and analyzed for overall reasonableness.	☑		
2	At the end of the monthly close process, the cumulative capacity purchase agreement amount booked to the general ledger is compared against supporting invoice totals.	☑		
3	Calculation process is reviewed by senior management.		☑	☑
4	Capacity purchase departure rates, margins, or both, are established annually and approved by financial planning and senior management.			☑
5	Capacity purchase expense journal entry is reviewed monthly by appropriate personnel.	☑		
6	Incentive items are reviewed and reconciled, and the prevailing margin rebate calculation is verified.		☑	☑
7	Trend and key performance indicator analysis of trued up expenses is performed, with unusual items investigated and followed up timely.	☑		☑

2.1.16

	Process: Estimate Excess and Obsolete Inventory Reserves **Transaction Type:** Estimation	**Example Significant Accounts Affected:** Inventory Reserves and Related Income Statement Accounts		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Appropriate personnel provide input into the assumptions.			☑
2	Assumptions for excess and obsolete inventory (including fleet plan modifications) are reviewed.			☑
3	Assumptions are updated based on retrospective review of prior year results.			☑
4	Costs by department and division are compared to budget.			☑
5	Count teams review and tag excess and obsolete items.	☑		
6	Excess and obsolete inventory calculation is reviewed.	☑		☑
7	Inventory subledger is reviewed.	☑		
8	Slow moving and excess inventory is monitored for obsolescence issues.	☑		
9	System automatically tracks inventory movement through the use of inventory type indicators.	☑		
10	The system is designed to generate an excess and obsolete inventory report based on inventory levels and projections.			☑

2.1.17

	Process: Revenue Breakage	**Example Significant Accounts Affected:**		
	Transaction Type: Estimation	Provisions, Accrued and Other Liabilities, Deferred Income		
		Revenue/Sales		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	A report displaying all journal entries yet to be posted is reviewed on a frequent basis.	☑		
2	A third-party statistician validates yields monthly. (Lift bases only)			☑
3	Account reconciliations are reviewed quarterly by the controller.	☑	☑	☑
4	Advanced recognition of revenue breakage is reviewed and approved by appropriate personnel.	☑		☑
5	Appropriate personnel provide input into the assumptions.			☑
6	Assumptions used to calculate revenue breakage are reviewed and reassessed periodically.			☑
7	Consistent and timely reviews are performed by management, with additional analyses performed during extraordinary business events			☑
8	Management analyzes regression analysis and other indicators/analyses for consideration of adjusting the breakage rate.			☑
9	Management reassesses the breakage rate assumptions and methodology.			☑
10	Revenue breakage amounts are reconciled to revenue system reports.	☑		☑
11	Variances between the flight segments flown and recorded are reviewed weekly and investigated as necessary.	☑		

2.1.18

	Process: Route/Long-lived Impairment **Transaction Type:** Estimation	**Example Significant Accounts Affected:** Intangibles, including Goodwill and Related Amortization		
	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
1	Appropriate personnel review a detailed asset listing that is extracted as support for the carrying values of the assets tested. On the recoverability test, appropriate personnel compare this listing to the general ledger balance for completeness.	☑	☑	☑
2	A second asset listing is generated after the writedown has been recorded, if necessary. Using the second asset listing, appropriate personnel review the accounting entries and any adjustments to the remaining life and residual value.	☑		
3	Cash flow analysis used in impairment calculation is independently reviewed for reasonableness and accuracy.			☑
4	Fair value selected by the entity is compared to documented third party appraisals, published market information, documented bids, or published information concerning recent transactions.			☑
5	Fleet plan changes are reviewed quarterly for criteria leading to possible impairment analysis (that is, temporary/permanent groundings).	☑	☑	
6	Gate usage is reviewed quarterly with Real Estate to determine if a potential impairment trigger exists.		☑	
7	Route acquisition cost is reconciled monthly to the general ledger.	☑		
8	Status of fleet transactions is regularly reviewed with Fleet Transactions personnel.		☑	
9	When an impairment is recorded, the financial analyst verifies that the percentage of fleet inventory written down matches the impairment taken on the aircraft values, and that the change in reserve for fleet inventory matches the impairment charge.	☑		☑

2.1.19

	Controls	Completeness	Existence/Occurrence	Valuation/Allocation
	Process: Payroll	**Example Significant Accounts Affected:**		
	Transaction Type: Estimation	Operating Expenses (Payroll)		
	The following payroll matrix only identifies payroll controls unique to the airline industry (that is, flight pay).			
1	Flight system configured to interface with payroll processing system to post hours flown.		☑	
2	Changes to the master tables in the flight system detailing labor rates and work rules specified in the contract are approved.			☑
3	Exception reports are processed by the system comparing hours processed to various measurements to ensure integrity of the data (for example, time posted versus time flown).	☑	☑	
4	Analysts review and clear exception reports with proper approval.	☑	☑	

Exhibit 2-2

Examples of Substantive Procedures

Exhibit 2-2 sets forth example substantive audit procedures that would be performed, as appropriate, to reduce the audit risk of the engagement. This list of substantive procedures is not all-inclusive, but intended to provide the auditor with examples of the audit procedures to address the audit issues that are typical for airlines. Additionally, this listing of example substantive procedures is designed for integrated audits in which the auditor performs both a financial statement audit and an audit of internal control over financial reporting. Therefore, many of the substantive procedures that are expected to be performed to reduce the audit risk for each assertion to an acceptable level are performed as tests of controls (for example, account reconciliation testing to address completeness and existence). Selected key controls are included in exhibit 2-1 to this chapter.

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Cash, including bank balances					
Review contracts and other agreements to determine that restricted cash is properly classified and disclosed.				✓	✓
Marketable Securities					
Review contracts and other agreements to determine that marketable securities are properly classified and disclosed in accordance with the applicable financial reporting framework.				✓	✓
Inventories					
Reconciliation of fuel inventory:					
Test the reconciliation of the fuel inventory to the general ledger. Investigate large and unusual reconciling items.	✓	✓			
Inventory reserves:					
Inquire of significant fleet plan modifications and consider the effect on inventory reserves.			✓		
Consumable parts reserve:					
Test the reasonableness of the allowance for obsolescence of consumable parts over the related fleet lives, including evaluating the assumptions used to calculate this allowance.			✓		✓
Long-term receivables, noncurrent deposits, and other long-term financial assets					
Credit card holdbacks:					
Obtain the credit card holdback agreement. Conclude on proper classification of the holdback based on the contractual provisions.					✓
Confirm significant credit card holdbacks with the credit card company.	✓	✓			

(continued)

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Insurance proceeds receivable:					
Obtain detail of accident insurance proceeds receivable. Agree to general ledger and test selected items by agreement to third party insurer information.	✓		✓		
Evaluation of accident receivables:					
Evaluate the collectability of accident receivables from insurers based on the client's analysis and credit rating of associated insurer.			✓		
Property, plant, and equipment, and related income statement accounts					
Purchase deposits:					
Obtain the schedule of purchase deposits with airline manufacturers. Verify the existence of purchase deposits through confirmation with aircraft manufacturers or examination of supporting documents.	✓	✓	✓	✓	
Aircraft deliveries:					
Inquire about significant arrangements to defer or cancel aircraft deliveries. Evaluate the accounting effect, if any, including valuation of purchase deposits and propriety of capitalized interest.		✓	✓	✓	
Obtain new aircraft acquisition agreements. Review of purchase incentives, maintenance credits, or other unusual terms. Conclude on propriety of accounting for such items.			✓		
Obtain detail of aircraft modifications. Conclude on appropriateness of capitalization of such modifications and related accounting for any replacement parts.		✓	✓		
Rotable parts:					
Review the reasonableness of depreciation expense for rotable parts and evaluate the need for obsolescence write-downs of rotable parts.		✓	✓		✓
Fleet Planning:					
Obtain the fleet plan and inquire about significant modifications to the fleet plan. Evaluate the accounting effect, if any, including whether impairment indicators exist. Test the related impairment charge under the appropriate accounting model.			✓		

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Inquire of any aircraft groundings and conclude on appropriateness of temporary or permanent grounding based on management fleet plan. Conclude on appropriate accounting as either held for sale or held for use based on these plans.			✓		✓
Leasehold Improvements:					
Obtain detail of leasehold improvements at airport facilities. Conclude on the appropriateness of the amortization period based on the contractual lease term or the economic lease term, considering the criteria set forth in the Audit and Accounting Guide *Airlines*.			✓		
New leases:					
Determine that new leases entered into during the year have been properly recorded and classified as operating or capital leases.	✓				✓
Based on review of new lease agreements/structures, conclude on proper application of the guidance at Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-15.					✓
Operating leases:					
For all operating leases with step rentals, lease incentives (for example, up-front cash payments, payments for moving costs or leasehold improvements, or assumption of a pre-existing lease), or rent holidays, test that the computation of rent expense and capitalization of deferred items is in accordance with the client's accounting policies or applicable financial reporting framework.	✓		✓		✓
Onerous leases, deterioration, and repair obligations:					
Consider the need for a provision relating to onerous leases. Also, consider the need for provision for deterioration and repair obligations arising in connection with lease agreements.	✓		✓		✓
Inquire of management's plan for returning leased aircraft based on lease expiration terms. Conclude on appropriateness of lease return condition accruals based on the fleet plan and contractual provisions.	✓		✓		✓

(continued)

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Intangibles, including Goodwill					
Annual international route authority analysis:					
Review the appropriateness of the annual international route authority impairment analysis and verify that related assets are carried in accordance with client's accounting policies or applicable financial reporting framework.			✓		✓
Assess effect of changing legislation/international regulations on realizability or amortization period of routes.			✓		
Other intangibles:					
Verify the existence of other intangibles, (for example, restricted entry routes, airport gate rights, slots, and airport operating rights). Test that they are carried in accordance with the client's accounting policies or applicable financial reporting framework.		✓	✓		✓
Amortization of gates and slots:					
Review the reasonableness of the amortization of gates and slots over the appropriate life of such assets by reference to the client's accounting policies or applicable financial reporting framework.			✓		
Provisions, accrued and other liabilities, deferred income					
Interline reserve reconciliation:					
Obtain a reconciliation/analysis of interline reserves. Inquire of significant changes to assumptions used in calculating the reserve. Agree inputs to source documentation. Investigate any large or unusual reconciling items.	✓	✓	✓		
Environmental liability evaluation:					
Obtain a schedule of environmental liability. Test selected balances and changes in account by agreement to third party information (for example, engineering studies). Investigate large or unusual items. Where a reserve has not been established, confirm that a history of exposures does not exist.	✓	✓	✓		
Frequent flyer cost accrual reconciliation:					
Obtain a reconciliation of frequent flyer incremental cost accrual. Agree inputs of the liability calculation to source documentation. Inquire about changes in the method used to value accrual. Investigate large or unusual reconciling items.	✓	✓	✓		

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Frequent flyer deferred revenue reconciliation and analysis:					
Obtain a reconciliation and analysis of the frequent flyer deferred revenue account. Agree additions to source documentation. Inquire of significant changes to assumptions utilized to determine the deferred revenue balance. Investigate large or unusual reconciling items. Evaluate whether the expected life of the travel award on which amortization is recorded is reasonable and applied properly.	✓	✓	✓		
Conclude on valuation revenue deferred for miles sold to affinity partners based on evidence of fair value in similar transactions.			✓		
Unearned Revenue:					
Obtain a reconciliation of unearned revenue. Investigate large and unusual reconciling items and agree balance to the general ledger. Agree subsidiary ledger balance to revenue accounting system.	✓	✓	✓		
Investigate aging of unmatched usage, including comparison of balance to prior periods. Conclude on whether any amounts need to be written off.		✓	✓		
Transportation taxes:					
Obtain reconciliation of transportation tax clearing, payable, and reserve accounts. Inquire of any balances outstanding in the clearing accounts. Test reconciliation of transportation tax payable to revenue system. Test any significant reconciling items. Conclude on appropriateness of tax reserve exposures based on underlying support.	✓	✓	✓		
Accident payable reconciliation:					
Obtain a reconciliation of catastrophic accident liability. Agree selected variances from prior periods to insurer reports and cash payments. Investigate large or unusual reconciling items.	✓	✓	✓		
Cargo Claims Reserve:					
Obtain entity's analysis supporting cargo claims reserve. Agree assumptions to underlying detail and conclude on adequacy of reserve, consistency of methodology, and comparison to historical experience.			✓		
Rent leveling computation:					
Obtain support for the rent leveling accounts. Test computation of selected balances and agree lease terms to respective lease agreements.	✓	✓	✓		

(continued)

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Medical insurance and workers compensation accrual:					
Review medical insurance and workers compensation accrual to determine if it is appropriate. Determine that the amounts appear to be reasonable in comparison with prior years and in consideration of our understanding of the client's business and changes to it. Test assumptions which support accrual.	✓	✓	✓		
Derivatives/Hedging/Commitments/Contingencies/Consolidation					
Hedge effectiveness:					
Test that the client's analysis of their derivative instruments is effective and properly recorded in accordance with client's accounting policies or applicable financial reporting framework.	✓		✓		✓
Guarantees:					
Obtain detail of the entity's guarantees. Based on discussion with appropriate department personnel (for example, legal, treasury, purchasing) conclude on whether guarantees need to be recorded, disclosed, or both, under the provisions of FASB ASC 460, *Guarantees*.	✓	✓	✓	✓	✓
Consolidation of Variable Interest Entities:					
Apply the accounting framework under FASB ASC 810, *Consolidations*, to the airline's variable interests. Consideration would include lease arrangements, fuel farms, aircraft financings, equity method investments, and other arrangements as outlined in the Audit and Accounting Guide *Airlines*.			✓		✓
Obtain management's residual return analysis and conclude on the entity's assessment of primary beneficiary. Test the underlying assumption in the residual return analysis.			✓		
Airport Financings					
Test the proper accounting of current year airport financings under the accounting of FASB ASC 840-40-55-2. Conclude on proper classification as debt or lease under the accounting standard.					✓
Upon completion of construction of airport facilities, conclude on appropriate accounting for arrangement as a continued lease, or sale-leaseback under the applicable accounting literature.			✓		✓

Significant Account/Examples of Substantive Procedures	Completeness	Existence/ Occurrence	Valuation/ Allocation	Rights & Obligations	Presentation & Disclosure
Revenue/Sales					
Revenue analysis:					
Obtain entity's analysis of revenue recognized. Agree to revenue recognition system and test significant reconciling items.	✓	✓	✓		
Revenue breakage analysis:					
Obtain the client's analysis of revenue breakage. Inquire of any changes to the assumptions utilized to calculate breakage. Agree breakage amounts to revenue system reports.			✓		
Revenue breakage advances:					
If the client advances recognition of revenue breakage, obtain analysis supporting advanced rate. Test selected inputs to analysis and inquire of any changes to the assumptions used.			✓		
Capacity Purchase Agreements:					
Obtain and read the capacity purchase agreement. Conclude on appropriateness of airline's accounting for elements within the contract including (1) lease considerations, (2) gross versus net, and (3) revenue recognition.			✓		✓
Revenue adjustments (Cargo):					
Obtain entity's analysis of revenue rebates, adjustments, and credits. Conclude on reasonableness of related reserve based on historical experience.			✓		
Capacity guarantees:					
Obtain entity's analysis of penalties owed under capacity guarantee contracts. Conclude on completeness of analysis and proper accounting.			✓		
Maintenance					
Obtain new power by the hour (PBTH) contracts executed. Read terms of the lease agreements and conclude on appropriateness of expense recognition under the terms of the PBTH contract and accounting guidance set forth in the Audit and Accounting Guide *Airlines*.	✓		✓		

Chapter 3

Marketing, Selling, and Providing Transportation[1]

Introduction

3.01 Airline revenue is derived primarily from the carriage of passengers, cargo, and mail. The primary emphasis of this chapter is on passenger revenue, which is a passenger carrier's main operating revenue, and frequent flyer programs (FFPs), which are generally a passenger carrier's primary marketing activity. Discussions of revenue recognition issues related to air cargo and regional carriers are included in chapters 8, "Air Cargo Operations," and chapter 9, "Regional Airlines," respectively.

3.02 Per Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-10-25-1, revenue recognition generally involves consideration of two factors: (*a*) being realized or realizable and (*b*) being earned.

3.03 Because airline tickets are usually sold in advance of the transportation date, the ticket sale date seldom coincides with the revenue recognition date, which is also referred to as the *service date*. According to FASB ASC 908-605-25-1, the following describes the twofold task for airline revenue accounting:

- To record unearned revenue (air traffic liability [ATL]) when a ticket is sold and scheduled service is at a later date
- To recognize revenue when the carrier provides the transportation service and thereby completes the earnings process

3.04 Revenue accounting is the most complex accounting area for airlines and their auditors. Many changes have occurred in the airline industry since 1980. Before 1980, airlines used two primary methods to recognize revenue on tickets, generally referred to as the *sales/use match* and *sampling* methods. The primary difference between the two methods is that the sales/use match method matches transactions and recognizes revenue at the ticket level (based on tracking and reporting of the actual activity related to each ticket sold), whereas the sampling method treats the total unearned revenue as a pool and focuses on valuing coupons (also referred to as a *segment* or one *leg* of the ticket) and recognizing revenue based on that valuation. Both methods were acceptable and, after the application of appropriate control processes, accomplished substantially the same result. Since 1980, new information technology systems, most of which are based on some form of the sales/use match system, have been developed to better meet airlines' revenue accounting needs. During the decade

[1] This chapter contains numerous references to fair value. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement and Disclosures*, applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances.

However, as stated by FASB ASC 820-10-15-2, FASB ASC 820 does not apply under accounting guidance that requires or permits measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value.

after deregulation, ticketing and fare rules became more complex, as airlines tried to restrict access to their lowest fares, resulting in Saturday-night-stay requirements, nonrefundable tickets (including exchangeable tickets that are not refundable), and change fees being applied to certain ticket exchanges. In addition, during this period, FFPs became a primary sales and marketing tool used by airlines to promote customer loyalty. The accounting for FFPs is still one of the most complex and subjective areas in airline accounting. Finally, with the expansion of low-cost carriers in the late 1990s, fare rules in some cases simplified, and low-cost airlines further simplified their processes by, among other things, not interlining with other carriers, not using travel agents or others to sell their tickets, and eliminating ticket variables by generally using nonrefundable but exchangeable tickets.

3.05 This chapter provides information about the processes that occur in the complex and varied airline revenue accounting systems of today.

Process Description

Airline Pricing

3.06 An airline's pricing strategy has a significant effect on its revenue. Pricing strategy depends on a number of factors including the type, number, and configuration of aircraft (single class versus multiple classes), marketing alliances, and route structure (hub and spoke or point to point).

3.07 Pricing is usually a function of the overall health of the economy, passenger demand, and industry capacity. A challenge for the industry is to meet the demand for air travel without adding excess capacity, which would affect pricing negatively. Airlines must also survive periods of slowed economic activity, which also tends to lessen demand. Because air travel is largely a commodity-type business, airlines usually attempt to ensure that the pricing of their product is competitive. This is particularly important because most travel is sold through Global Distribution Systems (GDS) or other forms of electronic distribution (for example, Internet sites of the airline and third-party travel agents) that allow travelers to easily access and compare pricing information.

3.08 There are other factors involved in determining pricing. One key factor is an airline's management philosophy. Some airlines focus on high passenger volume at lower prices, whereas others focus on so-called "premium passengers" and accept lower load factors. Philosophies are subject to variation because airlines may purposely keep their fares low or drop their fares further to generate more revenue. If those airlines are large enough competitors, other airlines may match their fares across the board to remain competitive. If it is a smaller airline reducing fares, other airlines can match selectively in order to minimize revenue dilution. As low-fare, low-cost airlines continue to grow, market share pricing trends continue to move to simplified low fares across most markets.

Sources of Airline Revenue

3.09 Traditionally, approximately 90 percent of passenger carriers operating revenue (excluding subsidies) has been derived from passenger operations, including revenue from upgrades from one class of service to another, baggage fees, and preferred seat assignments. This revenue is classified as passenger revenue. Other operating revenue is derived from air cargo operations, principally air freight and mail services. Additional sources of other operating revenue include sales of goods and services including food, beverages, headsets, frequent flyer miles, fuel, contract maintenance, passenger handling, and paper ticket fees. Many airlines also charge airline transaction fees for services performed, such as ticket change fees and reservation fees (for using an agent and not the Internet). These fees are classified either as passenger or other operating revenue. Some of these items are discussed in greater detail subsequently in this chapter.

Industry Resolutions

3.10 Two main airline governing bodies establish industry specifications and guidelines for reservations and ticketing. The Air Transport Association of America (ATA) publishes the Passenger Traffic Resolutions Manual (PTR), which contains the reservation, ticketing, and customer handling requirements for paper and electronic tickets (e-tickets). The International Air Transport Association (IATA) publishes the Multilateral Interline Ticketing Agreement, which is used to apply pricing and prorate values to international itineraries. Most airlines are members of ATA, IATA, or both. However, even nonmember airlines based in the United States adhere to the ATA's PTR in their dealings with other airlines.

Ticketing

Ticket Types

3.11 A ticket for air transportation may be issued weeks or months before the scheduled departure date. Airlines sell two types of tickets: paper tickets and e-tickets. A paper ticket consists of multiple coupons indicating the passenger's itinerary. One coupon is the *auditor's coupon,* which is the initial document used to record a sale. Additional coupons, referred to as *flight coupons*, represent each flight segment (leg) of the passenger's itinerary. Flight coupons are lifted (detached from the ticket booklet) by the carrier providing the transportation service at the boarding point as evidence of the service rendered, although today this process is entirely electronic for the vast majority of ticket sale and boarding transactions.

3.12 An e-ticket reflects the passenger's itinerary in electronic form. Like paper tickets, e-tickets contain information for each flight segment of a passenger's itinerary. In all cases, the airline's host reservation system or GDS produces an e-ticket sales record for each sale transaction, and the airline's revenue accounting department receives and processes the e-ticket sales records. Boarding documents are issued for e-tickets, and the carrier documents transportation service at the boarding point by either collecting boarding documents or scanning them as evidence of the service rendered.

Ticket Classifications

3.13 Tickets are usually sold in 2 general categories of fare rules: (*a*) refundable/unrestricted fare types or (*b*) nonrefundable/restricted fare types. An unused ticket (either entire ticket or partially used ticket) for a scheduled flight may expire unused, eventually be refunded, used on another carrier for the same itinerary, rerouted and reissued for a different flight, or otherwise become invalid for travel. A refundable/unrestricted ticket may be returned for a refund, used, or exchanged with no or few limitations. A nonrefundable/restricted ticket has a number of restrictions on its use and will rarely, if ever, result in a refund to the customer. Many airlines also charge fees (ranging from $30 to $250) for making any change to restricted tickets, referred to as *change fees*, in addition to charging for differences in fares. Also, many airlines may not permit any further use of the ticket after the scheduled flight date if the passenger has not called ahead to cancel the reservation and has not flown any segment or leg of the scheduled itinerary. All fare rules pertaining to the fare type are listed in the airline's fare rules or in their contract of carriage. A ticket (entire ticket) is generally valid for 1 year, with the specific period identified in a statement printed on the ticket or e-ticket receipt. Partially used nonrefundable tickets generally are invalid if not used on the scheduled date of travel. All tickets have an expiration date, at which time they become invalid.

Interline Ticketing

3.14 Some airlines issue tickets that may only be used for transportation on the airline's own flights and provide transportation only to passengers holding tickets issued by the airline. Those airlines are referred to as *noninterline airlines*. Other airlines have agreed to provide transportation interchangeably with other carriers. Those airlines are referred to as *interline airlines*. A ticket sold by an airline in which transportation on all flight segments will be provided only by that airline is referred to as an *online* (OL) *sale*. A ticket sold by one airline that includes flight segments to be traveled on another airline is referred to as an *offline* or *other airline* (OAL) *sale*. One ticket can include several flight segments, which may include flights on various carriers. The carrier that issues the ticket, known as the *OL carrier*, collects the total fare from the passenger. The OL carrier then settles the fare with the other carriers on which transportation is scheduled, known as *OAL earners*, on the basis of interline agreements (described in a subsequent section of this chapter). Some airlines have bilateral interline e-ticket agreements with OAL carriers whereby the usage of OAL segments is processed and settled electronically (described in a subsequent section of this chapter).

Sales Reporting

3.15 Tickets may be sold by airline ticketing agents at airports or ticket offices, in reservation centers, over the Internet, or by domestic or worldwide travel agents. Tickets are generally paid for in cash, by check, by various credit cards, or by the exchange of a previously purchased ticket. In the United States, credit card sales generally represent a significant portion of new sales transactions. See the "Credit Card Holdbacks" section of this chapter for a discussion of accounting and reporting of credit card holdbacks.

Airline Sales

3.16 A significant portion of an airline's operating revenue is generated through sales made to customers over the phone through the airline's reservations center, via the airline's website, or via third party sellers. Customers may also purchase tickets at airline locations, including airport stations and city ticket offices. The majority of tickets are e-tickets. All airline sales are controlled and processed in a similar manner.

3.17 Airline sales and refund activity are reported to revenue accounting. The reporting can be accomplished via online computer processing, with each ticket priced and recorded automatically. Reporting can also be performed manually by preparing daily ticket sales reports, which detail sales by ticket number. Under both systems, auditors' coupons and e-ticket sales records are sent to revenue accounting for verification.

3.18 The accounting entry for airline sales recognizes cash received and credit card receivables with corresponding credits to the ATL and related transportation tax liability accounts.

Direct Reporting Sales

3.19 Airlines can offer ticketing capability (booking, ticketing, direct reporting, and settlement) directly to businesses, travel agencies, or other industry-related entities. These ticketing transactions would typically be processed by the airline's host reservations system, and tickets may be issued through various websites and Internet connections.

3.20 Direct report sales are generally embedded in the airline's own sales and reporting process and processed and recorded as airline sales.

Travel Agency Sales

3.21 A large portion of airline industry ticket sales (other than on low-cost carriers) is generated through travel agencies. Accordingly, the settlement of sales proceeds due to the airlines and commissions due to the agencies is an important aspect of revenue accounting.

3.22 The processing of sales made by U.S. travel agents and the related accounting for such sales is conducted under rules established by the Airlines Reporting Corporation (ARC), which is an entity owned and operated by the airlines to facilitate travel agency reporting. Under ARC's carrier and agency agreements, agency area settlement banks serve as intermediaries between domestic travel agencies and airlines for the processing and settlement of sales records. International travel agency sales are processed through a regional or country bank settlement plan. International travel agency sales processing is similar to ARC processing.

3.23 A travel agency indicates the airline to which a ticket sale is to be credited by the coding of designated or undesignated ticket stock. The travel agency also includes the tax and commission codes on the auditor's coupon or e-ticket sales record. The agency uses ARC's Interactive Agent Reporting tool to finalize and process its sales report to ARC in accordance with a reporting schedule on a daily basis. ARC transmits the processed sales records to each airline electronically, generally without paper coupons or any other support. The settlement between the agencies and the airlines is accomplished according to the schedule determined by ARC.

3.24 The area settlement bank processes these documents and records and prepares invoices and reports necessary for settlement, including travel agency sales reports by airline and by agency. The bank makes the settlement for the tickets sold by the agencies for those airlines with accounts at the bank. The bank also submits invoices and associated charges to the respective credit card processors, which calculate the net amount of the settlement (sales less credit card fees) and make direct payment to each airline.

3.25 The accounting entry for travel agency sales recognizes a receivable, net of the related fees and commissions, with corresponding credits to the ATL and related transportation tax and fee accounts. Carriers generally recognize commissions (agency and credit card) as a prepaid expense and then subsequently recognize expense when transportation service has been provided.

Sales Audit

3.26 A carrier's audit of sales can commence when all documents and records are received by the revenue accounting department. The degree of this audit function may range from 0 percent to 100 percent and depends on the airline's accounting policies and processing sophistication. The audit may include 1 or more of the following: verification of ticket number sequence, agreement of cash and charge sales with the sales reports, and, in some systems, ticket pricing and completeness of paper and e-ticket sales files. Fare differences noted during the audit can be charged back or credited to the travel agencies in the form of debit and credit memos. Accounting for these memos results in corresponding debits or credits to the ATL and related transportation tax accounts.

Payment Processing

3.27 Accepted forms of payment are cash, check, and credit card. Cash or checks are reported by the airline's ticket sales office via a deposit slip that is verified against sales reports. Carriers receive credit card receipts from each participating credit card company. The funds are received via wire transfer and are verified against the sales and refunds submitted daily to each credit card company.

Credit Card Holdbacks

3.28 Generally, the airline industry uses credit card processors to handle all the details of processing credit card transactions among the cardholder, the air carrier, and the issuing bank. The issuing bank maintains a cardholder's credit card account and pays out to the air carrier's account when the cardholder makes a credit card purchase.

3.29 Once billed, credit card transactions are subject to dispute by the cardholder. When a transaction is disputed by the cardholder, the amount of that transaction is subject to chargeback and becomes contractually recoverable from the airline.

3.30 In the airline industry, tickets for air transportation are often sold weeks or months before the scheduled departure date. During the period between sale and departure date, the credit card processor relies on an air carriers ability to provide transportation or the proceeds from sales transactions to reduce the risk of cardholder chargebacks. In the event an air carrier files bankruptcy, ceases operations, and fails to provide transportation to the ticketed passenger, the credit card processor is responsible for reimbursing the cardholder. This reimbursement becomes an unsecured claim on the estate of the bankrupt carrier.

3.31 To mitigate this risk, credit card processors may hold back certain proceeds from a carrier's sales transactions or require a carrier to deposit funds in an account held for the benefit of the credit card processor to cover any possible chargebacks or other disputed charges that may occur. Depending on the terms and conditions of the underlying credit card processing agreement, this holdback or reserve would generally be recorded by the air carrier as either accounts receivable or restricted cash. In addition, a traditional credit card holdback agreement—one that holds back some or all of the receivables due to the airline until the transportation is provided—would normally be reflected as a reduction of operating cash flows.

Travel Agencies

3.32 ARC acts as a clearinghouse for the U.S.-based travel agency industry to ensure timely reporting and settlement with travel agencies. ARC performs a variety of functions, including receiving sales reports and funds from member travel agencies on a daily basis. ARC then processes the credit card sales to credit card companies, which later remit payments directly to each carrier via wire transfer, subject to the credit card holdback agreements previously discussed. ARC combines all other travel agency transactions and then sends sales information and remits payments directly to the participating airline.

Other Airlines

3.33 The Airlines Clearing House (ACH) was established to expedite settlement of interline accounts between member carriers. Each member airline submits billing documentation weekly to the ACH. Debtor airlines are required to make funds available and subject to disposition of the clearing bank in an amount equal to or in excess of the amounts required for settlement. The clearing bank effects settlement by debiting the accounts of the debtor airlines and crediting the accounts of the creditor airlines with the net debit or credit balance as specified on the respective settlement documents.

Passenger Travel

3.34 Passengers present their paper tickets to the airline when checking in for their scheduled flight. Passengers with e-tickets may initiate check-in through the Internet, at a kiosk, or at a ticket counter. In all cases, the passenger is issued a boarding pass.

3.35 At the gate, as passengers enter the aircraft, the boarding agent collects the boarding passes or otherwise documents the boarding (for example, in some cases the boarding agent scans boarding passes issued for e-tickets without physically collecting them). Prior to departure, the agent balances the total number of passengers boarded with the number of collected boarding passes and otherwise documented boardings. Upon departure, the flight is closed out by the boarding agent, and the e-tickets are recorded as used in the reservation system. Generally, the status of an e-ticket changes from *okay* (meaning available for use) to *checked-in* and then to *used* once the flight has departed. The completed flight report contains the lifted flight coupons, boarding passes, and e-ticket boarding documents collected or processed as passengers entered the aircraft. The flight report is sealed and sent for processing to revenue accounting.

3.36 Generally, the majority of airline tickets, based on their underlying contract of carriage, are valid for one year from the date of sale; however, historically, a significant percentage of these tickets are actually used in the first few months after sale. Lifted flight coupons are scanned or keyed for entry into the revenue accounting system. Used e-ticket records are received from the airline's host reservation system and loaded into the revenue accounting system as well. Together, the paper and e-ticket records are recognized as earned revenue, whether they originate as OL or OAL sales.

Refunds, Exchanges, and Reissues

3.37 Several types of refunds and exchanges can be made for an airline ticket. They include full and partial refunds, reissue/even exchanges, reissue/refunds, and reissue/additional charges. All refunds are processed against the original form of payment and adhere to all refund and exchange rules for the fare. If a refundable ticket is surrendered in exchange for a ticket for a flight on a different route or on a different airline that carries the same fare, a reissue/even exchange is required. If a refundable ticket is surrendered for another ticket with a lower fare, a reissue/refund is required. If a refundable ticket is surrendered for a ticket with a higher fare, a reissue/additional charge to the passenger is required. If the original ticket is nonrefundable or restricted, a change fee and change in fare are frequently required in order to exchange the nonrefundable ticket for another ticket. However, refunds are issued rarely, if ever, on nonrefundable tickets.

3.38 Refunds and exchanges for refundable and nonrefundable tickets can be executed at company locations (airport or ticket office), by travel agencies, by the airline refund department, or by other airlines. Depending on the airline's policy, company locations may issue checks or credit directly to the customer or take applications for refunds. If it is a paper ticket transaction and a new ticket is required, the old ticket is collected from the passenger. The old ticket, the auditor's coupon of the new ticket, and refund checks or refund applications are batched and submitted to revenue accounting with the daily ticket sales report documents. The revenue accounting department sorts the refund documents, logs them in a control record, and sends them to refund accounting for pricing, auditing, and issuance of refunds.

3.39 If the refund or exchange for refundable and nonrefundable tickets is requested on an e-ticket, a refund or exchange entry is processed for the e-ticket record in the host reservation or in the GDS, causing the e-ticket to be cancelled in the reservation system. The e-ticket record is then sent electronically to the revenue accounting department for processing.

3.40 If a carrier executes an exchange for an OAL ticket, that carrier then bills the coupon value of the redeemed ticket back to the carrier that sold the ticket via the interline billing process. This exchange item is audited by the OAL carrier as part of the interline settlement process discussed subsequently in this chapter.

3.41 Refunds, exchanges for refundable and nonrefundable tickets, and change fees are recorded as adjustments to the ATL, accounts receivable, and cash accounts as part of the company, travel agency, and interline sales entries.

Statistics

3.42 Generally, the revenue accounting department is responsible for compiling the airline's traffic and passenger statistics. The statistics may be for internal use or for financial, Department of Transportation (DOT), or other governmental reporting. Traffic statistic records should agree to other compiled operational statistics, such as on-time performance. See the "Analytical Procedures" section in chapter 2, "General Auditing Considerations," for an expanded discussion of statistics.

Air Traffic Liability

3.43 When a passenger ticket is sold, the selling carrier records a cash receipt or account receivable and unearned transportation revenue. ATL is the value of unused transportation sold by the reporting air carrier. This includes the liability for transportation to be provided by the carrier selling the ticket, as well as a liability for transportation that may be provided by other air carriers.

3.44 Under the umbrella of the ATA, members are permitted to establish procedures for handling interline operations. The details for these procedures are set forth in three primary interline agreements: ATA ticket and baggage agreement, the IATA bilateral agreement, and a multilateral agreement. Some airlines participate in one or more agreements. The agreements cover interline passenger ticketing, cargo, and baggage procedures; specify the source of accepted published fares; and describe the process of settling funds between participating airlines. The interline agreements exist to simplify the ticketing process for air travelers and to minimize the number of tickets necessary to complete an itinerary that involves more than one air carrier.

3.45 Under the interline agreements, the air carrier providing the first flight shown on a ticket for a multicarrier itinerary is allowed to issue a ticket for the entire trip and collects the total fare from the passenger. As a general practice, however, the carrier making the reservation issues the ticket even if it is the second carrier. Airlines have many marketing alliances with other carriers, such as code-sharing arrangements. In the case where two carriers share a marketing code, the marketing carrier (that is, the carrier whose code is on the flight) generally issues the ticket. The issuing carrier then prorates the fare among the carriers providing service on the itinerary based on the interline agreements in effect. Proration is a method of dividing the total fare among carriers according to the joint fares published in the Industry Prorate Manual or in accordance with existing agreements between code-share or alliance partners, which are frequently referred to as *special prorate agreements*.

3.46 As a result, the total fare value of the ticket is recorded in the ATL account of the issuing carrier and includes both the issuing carrier's liability to provide air transportation to the passenger and its liability to other carriers for their portion of the itinerary. Although part of a carrier's ATL account represents interline amounts payable to other air carriers or a refund obligation, other air carriers are also issuing interline tickets on which the carrier has an obligation to provide service.

3.47 The carrier reduces unearned revenue in the ATL account and recognizes earned revenue from OL sales when transportation service is provided. The basic methods of accounting and invoicing other airlines after transportation service has been provided and other revenue accounting issues are described in the following sections of this chapter.

Revenue Accounting Issues

General

3.48 In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. SAB

No. 104 provides the SEC's views on applying generally accepted accounting principles to revenue recognition in financial statements and was not intended to change current guidance in the authoritative accounting literature.

3.49 FASB has a revenue recognition project on its agenda. The objective of the project is to develop conceptual guidance for revenue recognition and a comprehensive accounting standard on revenue recognition based on that guidance. Practitioners should stay alert to further developments.[2] Revenue accounting in the airline industry has evolved over a number of years and is based on existing accounting principles and related guidance. The following sections describe current revenue accounting methods, processes, and issues and include an example passenger revenue recognition model.

Revenue Recognition Methods

3.50 Lifted flight coupons and other electronic evidence of boarding (collectively referred to as *coupons*) are used as the basis for recording revenue. Tickets sold by the carrier providing transportation and used by the passenger are referred to as *OL coupons*. Tickets sold by other airlines and used by passengers on the operating airline are referred to as *OAL coupons*. Both OL and OAL coupons are evidence of passenger travel. OL and OAL coupons represent revenue to the carrier for the transportation service provided. If the carrier uses a sales/use match system, OL coupons support the credit entry to earned revenue. If the carrier uses a sampling method for recognizing revenue, OL coupons are surveyed to determine the credit entry to earned revenue. See the "Accounting" heading in the "Interline" discussion of this chapter for further information about revenue recognition for OAL coupons.

3.51 The two basic systems used for calculating earned revenue—the sales/use match and the sampling method—are described in the following discussions. However, with the advent of technology, few airlines continue to use a sampling-based method for revenue recognition. The preferred approach for calculating earned revenue is the sales/use match method. For purposes of this discussion, a *ticket* is defined as equaling the sales value of the entire transaction, excluding passenger taxes and fees as discussed subsequently in this chapter (that is, the combined value of all individual flight segments on an itinerary). A *coupon* is defined as the value associated with each individual flight segment and can be evidenced by lifted flight coupons and other electronic evidence of boarding the individual flight segment.

Sales/Use Match Method

3.52 The principal objectives of the sales/use match method are to record all sales information by ticket and to match the usage of all recorded tickets by coupons. In this kind of system, all OL tickets issued are recorded in the ATL account and tracked by ticket number, transaction control number (TCN),

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[2] On January 4, 2012, FASB issued a proposed Accounting Standards Update (ASU), *Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification*, to improve and align with International Financial Reporting Standards the financial reporting of revenue from contracts with customers and related costs. The core principle of the draft standard is that an entity should recognize revenue from contracts with customers when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer. The proposed standards would replace most of the guidance in FASB ASC 605, *Revenue Recognition*. Readers should be alert for the issuance of the final ASU.

or both. OL coupons are matched against the recorded tickets, and the coupon value is deducted from ATL and added to earned revenue. Interline billings to other airlines represent usage of OAL coupons and are recorded as earned revenue and accounts receivable. Interline payable billings by other carriers represent a usage of OL coupons, which are matched against the recorded tickets and deducted from the ATL account upon payment to the other carrier. Adjustments to the ATL account are made periodically for unmatched tickets, lost tickets, or tickets not processed for some other reason (ATL breakage is discussed subsequently in this chapter). Generally, in most sales/use match systems, the ticket amounts are determined from a sales-type record or TCN, and the itinerary is prorated by the type of fare construction and fare paid. When prorating the itinerary, the objective is to value each coupon based on its relative selling price in accordance with FASB ASC 605-25-25-2. These values are later used to determine revenue to be recognized upon travel.

Sampling Method

3.53 The objective of the sampling method is to recognize revenue on the basis of a survey of OL and OAL coupons for the period. There are two attributes for which a sample of coupons may be tested: number of revenue passenger miles (RPMs) or number of revenue passengers. If the RPM attribute is used, a sample of the dollar value of coupons is accumulated and divided by RPMs flown to produce an average yield per RPM. Average yield calculations are usually done for each segment (that is, origin and destination cities) in the airline's system. These average yields are accumulated for the number of passengers in the sample thus creating a weighted average yield for each segment. These weighted average yields are then multiplied by the total number of RPMs flown by the carrier for each segment to determine earned revenue. The number of passengers attribute system develops an average fare per passenger from the sample. Earned revenue is then determined by applying this average fare to the number of passengers transported for the period. The average yield per RPM is the more common attribute used for sampling systems and is more accurate than using an average fare.

3.54 Carriers use various methods to sample lifted coupons, for example, testing all lifted coupons with a number ending in a selected digit. If the airline uses statistical sampling methods, the independent auditor would consider whether the sampling plan has statistical validity, whether it has been applied properly, and whether the resulting precision and reliability, as defined statistically, are reasonable in the circumstances.

3.55 Per paragraphs 8–9 of FASB ASC 908-605-25, under the sampling method, all OAL coupons are initially recorded in the ATL account (in which OL tickets and coupons were previously recorded). All coupons (OL and OAL) are processed for the required sampling data (and for statistical data required by the DOT). Earned revenue is recognized on the basis of the sampling data for all coupons and is deducted from the total of tickets recorded in the ATL account. All OAL coupons are recorded in the ATL account to determine a total of all coupons sold by other airlines, from which revenue can then be recognized. Interline payable billings are deducted from the ATL account when they are paid. Differences, such as those arising from clerical inaccuracies between amounts originally recorded and amounts billed, may be rejected and rebilled or written off if the originally recorded fare was incorrect.

Interline

Accounting

3.56 OAL coupons are evidence of travel that supports interline receivables and revenue. The tickets were sold by another carrier and used on what is referred to as the *operating carrier*. The OAL coupons are processed to record revenue and to initiate interline receivable billings. OAL coupons are assigned a billing value in order to create interline billings to collect earned revenue. Some airlines assign a billing value to all of these coupons (this approach is referred to as *nonsample interline billing*), whereas others assign a billing value to a sample of coupons selected based on ticket number digits, which are published monthly by various airline agencies (this approach is referred to as *sample interline billing*). Frequently in sample interline billing, a standard pricing value is assigned to OAL coupons by the airline pricing system, which is later adjusted by a depressant (see discussion in the next paragraph regarding the term *depressant*). The pricing approach to be applied is agreed in advance between the two carriers. Pricing of coupons can be done manually, but for most airlines it is done via computer processing systems using a TCN record. A TCN is created when the host or GDS system generates a paper or e-ticket. The TCN record is received the next day by the issuing airline and by the airline that has a scheduled travel segment on an OAL ticket. The TCN can be used to reconcile the individual coupon values from the GDS (determined in the pricing process) to use in the airline's proration subsystem.

3.57 The statistical sampling size and methodology are outlined in the ACH *Manual of Procedures* and IATA *Revenue Accounting Manual*. In general, however, a billing airline that intends to bill actual fares runs the OAL coupons through a pricing system in an attempt to obtain the correct value of each ticket. The billing is then subject to auditing by the billed airline. In an attempt to simplify the process, some airlines bill at a local fare less a calculated depressant. The depressant is based on a historical ratio of standard local fares to settled fares and is used to adjust the current month's interline billings. The coupons within the sample are audited by the billed airline, and the billing adjustment is applied to the entire billing amount. Airlines need to consider providing reserves if history indicates that interline billings are frequently adjusted downward upon audit because audits can take up to six months.

Settlement of Interline Balances

3.58 To aid in billing interline receivables, the airline industry has established clearinghouse settlement plans in which most carriers participate. The settlement procedures are described in the interline agreements. The ACH performs this interline settlement function for most western hemisphere carriers, and the IATA Clearing House performs this function on a worldwide basis. Some airlines are members of both clearinghouses.

3.59 Periodically, airlines transmit summaries of their interline invoices to the clearinghouse, which tabulates and reports the balances of accounts receivable and accounts payable for each member airline. The net balances are also calculated periodically, on a weekly or monthly basis, and settlement is made through each participating airline's account. Each airline is also responsible for preparing invoices that detail the airline billed, the amount invoiced, and the tickets that were assigned a billing value. The invoice, including the supporting lifted paper tickets and e-ticket listing, is sent monthly to the appropriate airline.

3.60 Each carrier is responsible for auditing the interline billings that it receives. The audit is performed after settlement through the clearinghouse. Any differences noted in the audit are rejected and rebilled to the appropriate carrier in subsequent months. The percentage of tickets selected for audit (sampling or 100 percent) is a matter of the agreement between the airlines. If a sample is used, the sampling method and size of sample are agreed upon by each airline clearing with the billing carrier.

3.61 First and final settlement is a process that was developed by the global airline alliances established in the late 1990s as a way of eliminating many of the inefficiencies in the process. In first and final settlement, two carriers agree to an allocation of the price between the different segments at the time of ticket sales, thus avoiding all of the subsequent billing and rebilling that occurs under the traditional airline interline model.

Air Traffic Liability Verification

3.62 The ATL balance for the sales/use match method of revenue recognition generally is verified monthly by reconciling ticket-level detail contained in unearned revenue subledger files to the general ledger balances in ATL. A number of common reconciling items exist in this reconciliation, primarily unmatched usage, accrued sales, and ATL breakage, which are described in detail in the sections that follow.

3.63 In the verification of the ATL account under the sampling method of revenue recognition, each air carrier periodically verifies its passenger revenue accounting practices. The purposes of this verification are to assess the degree of reliance that can be placed on the carrier's earned passenger revenue and, at the same time, to test the balance in the ATL account.

3.64 To perform ATL verification under the sampling method, some airlines open a new ATL account for unearned revenue on the first day of the month in which the verification begins (generally three months prior to the airline's fiscal year end). Only credit entries for tickets sold for the new period are recorded in this account. All lifted coupons, refunds, exchanges, and liabilities for OL and OAL coupons are segregated between those sold in the prior period and those sold in the new period. The applicable amounts are charged to the appropriate period's ATL account.

3.65 The carrier verifies the prior-period ending balance by analyzing lifted coupons, refunds, exchanges, and invoices for a period within the current period. The length of time of the analysis varies but usually does not exceed 12 months. All transactions with a validation date (sales date) prior to the first day of the new period are accumulated in this analysis. The value of the prior-period tickets and coupons used in the verification may be derived from the priced fare of each prior-period lifted coupon, or it may be an amount determined by sampling the coupons.

3.66 Under either process, adjustments to the recorded ATL balance are frequently necessary. Common adjustments to ATL result from revenue breakage, partially used tickets, invalid nonrefundable tickets, pricing errors, computer processing errors, and so forth. See the "Passenger Revenue Recognition Model" discussion in this chapter. After a reasonable period, an estimate is made of remaining unused tickets (those sold in the prior period that are still expected to be used but are unused as of the current period), and the airline can assess the accuracy of its estimates and make necessary adjustments to future estimates.

Unmatched Usage

3.67 A key control in either a sales/use match or sampling system is the investigation of what is referred to as *unmatched usage*. Unmatched usage occurs when a passenger uses a ticket, and the airline has no record of the original ticket sale. Usage may be in the form of provided transportation, exchange, refund, or certain other form. With advances in technology, the number of tickets used that the airline has not recorded as sold has become extremely low. When unmatched usage occurs, it typically results from the use of a ticket prior to the sale being recorded through the sales reporting process, specifically for travel agency and international sales. In these situations, the ticket usage is ultimately matched with the recorded ticket sale, and revenue recognition occurs as of the date of travel. However, the investigation of unmatched usage can also identify sales that were incorrectly or never recorded by a travel agency or other sales agent and for which the airline still needs to collect the fare. The primary accounting issue associated with unmatched usage is valuation of coupons because the sale has not yet been recorded and, therefore, the actual amount for which the ticket was sold is not included in the revenue accounting system. In these circumstances, the revenue for passenger travel is generally recorded using the best information available to the airline. For tickets sold on a GDS, airlines frequently use TCN data provided by the GDS to recognize revenue on unmatched usage. If TCN data are not available, the airline may use other segment- or yield-based estimates to determine revenue for these tickets. Whichever method is used, an airline should track the accuracy of its pricing of unmatched usage and make corrections as appropriate to deal with any pricing issues identified.

ATL Breakage

3.68 ATL is the value of unused transportation sold by the air carrier and includes both the liability for transportation to be provided by the carrier selling the ticket and liability for transportation that may be provided by other air carriers. ATL also includes ATL breakage. Historically, *ATL breakage* has been defined as recorded ticket sales that remain partially or wholly unused after either the scheduled departure date or ticket expiration date. ATL breakage generally has included both the revenue breakage and invalid tickets, as defined in the "Ticket Validity" and "Revenue Breakage" sections.

3.69 Airlines have historically used a variety of methods to account for ATL breakage. One common method of accounting for ATL breakage includes recording an estimate of revenue breakage in the month of departure or the month of ticket expiration. As further discussed in the following sections, the AICPA Financial Reporting Executive Committee (FinREC) recommends that airlines should recognize revenue breakage for valid tickets at the date of expiration. FinREC believes that is the preferable accounting policy. However, FinREC believes that if certain conditions (set forth in the "Passenger Revenue Recognition Model" section) are met, an airline may elect to recognize breakage before expiration at the date when all services have been provided. If an airline meets those conditions and chooses to recognize breakage before expiration, revenue breakage may be recognized on the departure date.

Ticket Validity

3.70 For purposes of this discussion, *ticket validity* refers to the status of the ticket prior to its contractual expiration date (assumed to be one year from the date of sale). All unused tickets are either valid or invalid as determined by the specific airline's ticketing policies. A *valid ticket* is a ticket that maintains its validity (that is, the ticket has value and the customer can travel with the ticket, exchange it for future travel, or obtain a refund) until its contractual expiration date. An *invalid ticket* generally loses its value at departure date or, in certain circumstances, at some point subsequent to departure date but prior to its contractual expiration date.

3.71 The following table provides examples of valid and invalid tickets. Each category of valid and invalid tickets is discussed in the following sections. It is assumed that the departure date has passed in all of the following examples.

Invalid Tickets	*Valid Tickets*
• Nonrefundable/nonexchangeable tickets without continuing validity • Tickets involving gaming, for example, nonrefundable partially used tickets that have no continuing value based on fare rules	• Refundable tickets • Nonrefundable tickets with continuing validity • Travel vouchers issued for passenger inconvenience

Revenue Breakage

3.72 *Revenue breakage* is defined in this guide as the recognition of revenue before the airline has performed all its obligations under the sales arrangement because the customer has not required the airline to perform and is unlikely to do so. Revenue breakage consists of refundable and nonrefundable tickets that remain unused past departure date, have continuing validity (valid tickets), and are expected to ultimately expire unused, as well as valid travel vouchers that are not expected to be redeemed prior to their expiration date.

3.73 The passenger revenue recognition model described in this chapter discusses guidance on determining when to recognize revenue breakage for valid tickets and travel vouchers. FinREC believes that invalid tickets are not considered to be revenue breakage and recommends that they be recognized as revenue at the point when they become invalid, which is usually the departure date.

Nonrefundable Tickets

3.74 For many airlines, the majority of tickets sold are nonrefundable restricted-fare tickets, which carry lower prices and frequently require charges for fare changes and, in some cases, change fees (up to $250) before the ticket itinerary can be changed. In the past, certain carriers allowed customers with nonrefundable tickets to cancel existing reservations after the departure date and exchange the value of the canceled ticket for a ticket on another flight. In recent years, most carriers have modified their fare rules to eliminate customers' ability to exchange nonrefundable tickets if they fail to notify the carrier prior to the original departure date that travel will not occur. Regardless of the airline's ticket validation policy, revenue breakage (as defined herein) includes only those nonrefundable tickets for which the departure date has passed, that have continuing validity, and that are expected to ultimately expire unused.

3.75 For example, if a ticket is nonrefundable and requires notification in advance of the departure date in order to be exchangeable for future transportation, and if such notification was not made by the passenger, the ticket is invalid after the departure date. As such, revenue recognition at the departure date is appropriate because the airline has fully performed its obligation to the passenger. Such tickets are not considered revenue breakage but are recognized as revenue at departure date because the tickets become invalid at that point.

3.76 When estimating revenue breakage based on the passenger revenue recognition model described in this chapter, it is necessary to consider the effect of historical customer accommodations (for example, circumstances in which an invalid ticket or a formerly valid ticket past its expiration date is honored by the airline, generally for customer convenience reasons). FinREC believes that in order to recognize revenue from invalid tickets and revenue breakage prior to the ticket expiration date (as discussed in the "Passenger Revenue Recognition Model" section of this chapter), the airline would also have to demonstrate a history of not honoring invalid or expired tickets due to customer accommodations except in very limited circumstances.

Refundable Tickets

3.77 Revenue breakage includes only those refundable tickets for which the departure date has passed and that are not expected to be refunded or reissued for travel prior to their expiration date.

Tickets Involving Gaming

3.78 Gaming occurs in certain instances in which, due to airline pricing practices, it is more economical to purchase two round-trip tickets and use only one-half of each ticket, rather than purchasing one round-trip ticket for the intended dates of travel, or in instances in which a leg of a ticket is purchased with no intent to use the leg because the overall ticket has a lower cost than a ticket without the additional leg (referred to as *hidden cities*). Tickets that are unused and represent throw-aways, that contain hidden cities, or that involve other ticketing phenomena, commonly referred to by airlines as *gaming*, have no validity after the scheduled departure date because frequently the ticketing rules permit no refund or exchange of such tickets. Furthermore, the customer would not be entitled to any refund or exchange because the value of the ticket actually flown exceeds the value of the ticket purchased. As a result, FinREC recommends that revenue related to such items be recognized as of departure date.

Travel Vouchers

3.79 Travel vouchers are generally issued in connection with denied boarding situations in which a passenger is involuntarily denied boarding and placed on another flight and provided with a voucher as an accommodation for the passenger's inconvenience. Travel vouchers are also provided as an enticement for passengers to accept a voluntary change in flights. In denied boarding situations, the travel voucher is issued in addition to providing another flight to the customer to complete his or her originally scheduled trip.

Travel vouchers may also be issued to passengers as compensation related to other customer service issues. Travel vouchers are usually issued for either free travel (for example, a round trip anywhere in the United States, but usually excluding Hawaii and Alaska) or for a fixed amount (frequently ranging from $100 to $500) that can be used by the passenger to pay for future travel purchases from the issuing airline. Generally, travel vouchers cannot be refunded and expire one year from the date of issuance. Partially used travel vouchers frequently have no continued validity for the unused value. Unused travel vouchers have continued validity generally until their expiration date.

3.80 Travel vouchers are recorded at the date of issuance, which is usually the departure date of the ticket for which the voucher was issued due to passenger inconvenience. Airlines record the initial issuance of travel vouchers as either an expense or as a reduction of passenger revenue, depending on the carrier's policy; however, the total revenue recognized for the initial ticket and the voucher cannot exceed the cash collection from the passenger. FinREC believes that characterization of travel vouchers as a reduction of passenger revenue is preferable. Then, when travel vouchers are exchanged for tickets, revenue for the exchanged tickets is recognized upon travel in accordance with standard revenue recognition procedures described previously. Airlines record travel vouchers for dollars off at their face value and travel vouchers for free trips at the amounts that are based on similar tickets with comparable restrictions. Airlines also record breakage related to travel vouchers in accordance with their established policy.

Passenger Revenue Recognition Model

3.81 The following is an illustration of the application of the passenger revenue recognition model in the airline industry. It is based on guidance provided in the previous sections of this chapter and serves as a guide to the detailed discussion that follows. It is illustrative only and has been prepared to show how certain fact patterns might affect passenger revenue recognition. Revenue recognition decisions reached in this illustration are based on the assumptions listed in the next paragraph. Facts and circumstances of each individual airline should be considered in the application of this model.

3.82 The assumptions are as follows:

- All ticket sales and travel vouchers are recorded in ATL.
- Tickets and travel vouchers are valid for one year from date of issuance.
- Nonrefundable tickets (unused) become invalid on the scheduled travel date unless the customer complies with the airline's ticketing rules (no value after travel date).
- Nonrefundable tickets (unused) remain valid after the scheduled travel date if the customer complies with the airline's ticketing rules. Thereafter, 20 percent are never used prior to expiration (revenue breakage).
- Nonrefundable tickets (partially used) become invalid on the scheduled travel date.
- Refundable tickets (including partially used) can be refunded within one year.

- Refundable tickets (including partially used) can be exchanged within one year. No change fee is charged, but the airline either collects or refunds any difference in airfare.
- Ten percent of valid refundable tickets (including partially used) are never submitted for refund or exchange prior to expiration (revenue breakage).

3.83 Revenue recognition occurs as outlined in the following table.

Ticket Usage	*When the Revenue is Recognized*
Passengers using tickets	At actual travel date
Tickets that become invalid, generally on departure date, for which the customer does not comply with the airline's ticketing rules	At scheduled departure date
Revenue breakage for tickets	On the expiration date or, under certain conditions, on the scheduled departure date (see paragraphs 3.84–.87)
Revenue breakage for travel vouchers	On the expiration date or, under certain conditions, at the date of issuance because this is generally the departure date of the original ticket for which the voucher was issued due to passenger inconvenience

3.84 FinREC recommends that airlines recognize revenue breakage for valid tickets at the date of expiration. FinREC believes that is the preferable accounting policy. However, FinREC believes that if the conditions set forth in paragraphs 3.86–.87 are met, an airline may elect to recognize breakage before expiration at the date when all services have been provided. If an airline meets those conditions and chooses to recognize breakage before expiration, revenue breakage may be recognized on the departure date.

3.85 FinREC believes that departure date is an acceptable point at which to recognize revenue breakage, provided the conditions set forth in paragraphs 3.86–.87 are met, because the probability of redemption and the customer requiring performance become remote at that point. Furthermore, some believe that when the originally scheduled departure date has occurred and the ticket remains unused, the airline has performed its obligation to provide transportation.

3.86 FinREC believes the SAB No. 104 criteria for recognizing refundable membership fees provide a sound model for conditions that need to be met in order for revenue breakage to be recognized before ticket expiration. Accordingly, FinREC believes that the following conditions, if met, would provide a basis for supporting the recognition of breakage at the scheduled departure date:

- The estimates of breakage are being made for large pools of homogeneous items.

- Reliable estimates of breakage can be made on a timely basis.
- There is a sufficient entity-specific historical basis upon which to estimate breakage, and the airline believes that such historical experience is predictive of future events.

3.87 FinREC believes that in accordance with the first condition, breakage items that could be expected to have similar breakage patterns would need to be aggregated into pools. Generally, refundable tickets, nonrefundable tickets, and travel vouchers would be considered separate homogeneous pools. Depending on the circumstances, some of these categories may need to be broken down further. FinREC believes it is preferable that the accounting policy for breakage for each of these separate homogeneous pools be consistent. FinREC observes that start-up airlines would generally be unable to meet the third condition in paragraph 3.86 and, thus, generally would not recognize breakage prior to expiration. However, once an airline has sufficient history on which to base its estimates, it may choose to recognize breakage at departure date if the other two conditions in paragraph 3.86 are also met. In those circumstances, it would not be considered a change in accounting principle because the airline's accounting policy has not changed. In the example of a start-up airline, the airline's accounting policy from the beginning was to recognize revenue breakage prior to ticket expiration; however, the airline had to default to recognizing breakage at ticket expiration because it did not have sufficient history to estimate breakage. Once the airline accumulates a sufficient entity-specific historical basis upon which to estimate breakage, it would be able to begin recognizing breakage prior to ticket expiration.

3.88 An airline's breakage policy should be disclosed pursuant to FASB ASC 235-10-50-1.

Change and Other Transaction Fees

3.89 Change fees are charges imposed on passengers for making schedule changes to nonrefundable tickets. Such fees are intended to compensate the airline for allowing and completing the ticket exchange, including covering the cost thereof. Change fees are not refundable, have no separate value to the customer once paid, and do not attach to the ticket. In other words, if the ticket is exchanged again, only the value of the ticket (face value), exclusive of the change fee, could be used against the value of the new ticket, and another change fee would likely apply. The timing and methodology of charging change fees vary among airlines. Some airlines assess the change fee by reducing the face value of the cancelled ticket by the amount of the change fee at the time the customer notifies the airline that the original flight will not be taken. Other airlines assess change fees if and when the ticket is ultimately exchanged, which may occur before or after the original flight. If the customer does not comply with the airline's ticketing rules, the original ticket may become invalid and would not be permitted to be changed. See the "Passenger Revenue Recognition Model" section of this chapter.

3.90 The predominant industry practice is to account for change fees as a separate transaction independent from the original ticket sale. Under this approach, change fees are viewed as a separate transaction independent from the original ticket sale because the fees are charged subsequent to the initial sales transaction, there is no requirement on the passenger to pay the fees at the time of the original sale, and passengers who pay change fees receive additional utility that they are not otherwise entitled to (that of being allowed to exchange the original ticket and, therefore, preserve its value). Under this approach, revenue related to change fees is recognized when the fee is assessed, which might be when the original ticket is either cancelled or exchanged.

3.91 However, under an alternative approach, it is believed that there is only one deliverable—passenger transportation—and that change fees do not represent a separate revenue-generating event because the actual transportation is so significant to the overall arrangement that performance cannot be deemed to have taken place until the airline provides transportation to the passenger. As such, revenue related to change fees is recognized when the ultimate transportation service is provided.

3.92 Other transaction fees (for example, paper ticket fees, delivery fees, and reservation fees) are charged by airlines for providing various services. Airlines need to consider whether such fees are separate revenue-generating transactions under FASB ASC 605-25-25-1. Fees that qualify as separate units of accounting are generally recognized as revenue when the related service is provided and classified as other operating revenues. FinREC believes that fees that do not qualify as separate revenue-generating transactions should be deferred and recognized as revenue when the related transportation service is provided.

3.93 As a result of the difference in the nature of change and other transaction fees, some airlines classify this revenue as other operating revenue and not as a component of passenger revenue. Although diversity in practice exists in the classification of change and other transaction fees, either presentation is believed to be appropriate as long as the airline discloses the classification of change and other transaction fees if such amounts are material.

Taxes and Fees

3.94 The primary fees collected on each ticket by airlines are summarized in the following table.

TAXES AND FEES ON PASSENGERS

Type of Tax	*Percentage or Flat*	*Unit of Taxation*
Federal Ticket Tax (1)	Percentage	Domestic Airfare
Federal Flight Segment Tax (1)	Flat Fee	Domestic Enplanement
Federal Security Surcharge (2)	Flat Fee	Enplanement at U.S. Airport
Airport Passenger Facility Charge (PFC) (3)	Flat Fee	Enplanement at Eligible U.S. Airport
International Departure Tax (1, 4)	Flat Fee	International Passenger Departure
International Arrival Tax (1, 4)	Flat Fee	International Passenger Arrival
Immigration and Naturalization Service (INS) User Fee (5)	Flat Fee	International Passenger Arrival

(continued)

Type of Tax	*Percentage or Flat*	*Unit of Taxation*
Customs User Fee (6)	Flat Fee	International Passenger Arrival
Animal and Plant Health Inspection Service (APHIS) Passenger Fee (7)	Flat Fee	International Passenger Arrival
Frequent Flyer Tax (8)	Percentage or Flat Fee	Frequent Flyer Awards

TAXES AND FEES DIRECTLY ON THE AIRLINE

Type of Tax	*Percentage or Flat*	*Unit of Taxation*
Frequent Flyer Tax (9)	Percentage	Sale of Frequent Flyer Miles
APHIS Aircraft Fee (7)	Flat Fee	International Aircraft Arrival
Jet Fuel Tax (1)	Fee per Gallon	Domestic Gallon
Leaking Underground Storage Tank (LUST) Fuel Tax (10)	Fee per Gallon	Domestic Gallon
Air Carrier Infrastructure Security Fee (2)	Per Carrier	Calendar Year 2000 Screening Costs

NOTES

1. Deposited to the Federal Airport and Airway Trust Fund, which funds the majority of the Federal Aviation Administration annual budget.
2. Funds screeners, equipment, and other costs of the Transportation Security Administration.
3. PFCs are federally authorized but levied by local airport operators, which set the amounts (up to $4.50 per enplanement, to a maximum of 2 PFCs per 1-way trip and 4 per journey).
4. Does not apply to those simply transiting through the United States between two foreign points.
5. Funds inspections conducted by the U.S. INS.
6. Funds inspections conducted by the U.S. Customs Service. Passengers arriving from Canada, Mexico, U.S. territories and possessions, and adjacent islands are exempt.
7. Funds U.S. Department of Agriculture agricultural inspections, conducted by the U.S. APHIS. Arrivals from Canada are exempt.
8. A form of federal ticket tax imposed on passengers redeeming their frequent flyer awards.
9. A form of federal ticket tax, deposited with the federal Airport and Airway Trust Fund, imposed on proceeds from the sale of the right to award (frequent flyer) miles to third parties (for example, credit card issuers, car rental companies, restaurants, and hotels); became effective October 1, 1997.
10. Supports the LUST Trust Fund.

Taxes and Fees on Passengers

3.95 The taxes and fees assessed on the sale of tickets to end customers have traditionally been considered by airlines as taxes collected as an agent. Accordingly, all such taxes and fees have been presented on a net basis (that is, excluded from revenue and recorded directly as liabilities until paid to the respective taxing authority). Paragraphs 3–4 of FASB ASC 605-45-50 apply to any tax assessed by a governmental authority.

3.96 Taxes directly imposed on a revenue-producing transaction between a seller and a customer may include, but are not limited to, sales, use, value added, and some excise taxes, and therefore, include taxes and fees assessed on the sale of tickets to passengers. FASB ASC 605-45-50-3 provides that the presentation of taxes within its scope on either a gross (included in revenue and costs) or a net (excluded from revenue) basis is an accounting policy decision that should be disclosed pursuant to FASB ASC 235-10-50-1.

3.97 Therefore, an airline may choose to present those taxes on a gross basis, however, it has been the longstanding industry practice to present those taxes on a net basis because they are collected in the capacity of an agent. FinREC believes that net presentation is preferable. FASB ASC 605-45-50 also sets forth disclosure requirements that are discussed in chapter 7, "Financial Reporting and Disclosures," of this guide.

Taxes and Fees Directly on the Airline

3.98 Taxes and fees assessed directly on the airline are considered taxes and included in operating expenses in the carrier's financial statements. Jet fuel taxes are included as a component of fuel expense.

3.99 See chapter 10, "Special Reports and Example Reporting," for a discussion of certain fees and illustrative reports issued in attest engagements in connection with those fees.

Frequent Flyer Programs

Introduction

3.100 FFPs were introduced by many airlines in the early 1980s, principally to induce higher levels of repeat business from their customers. The basic concept of an FFP is to encourage passenger loyalty by providing awards geared to the frequency of travel on the sponsoring airline, typically in the form of frequent flyer miles, points, or segments (collectively referred to as *mileage credits*) that can be accumulated and converted into free or discounted travel.

3.101 Some airlines also enter into code-sharing or other arrangements whereby they cooperate with other airlines in providing travel-related benefits to passengers. Typically, such arrangements involve an ability to access one another's FFP so that members of one airline's FFP can use their mileage credits to obtain awards on another participating airline, earn mileage credits for flights taken on another participating airline, or both.

3.102 Some FFPs also involve participants other than airlines, for example, credit card issuers, hotels, car rental companies, and restaurants. The most prevalent nonairline participants in FFPs have historically been credit card issuers. Nonairline participants grant mileage credits as an inducement for the purchase of products or services. These nonairline participants pay the airline based upon the level of purchases for the ability to utilize the marketing benefits of the FFP. These programs can account for a significant portion of the mileage credits issued in an FFP.

3.103 In addition to free travel awards, various other types of awards may be offered by an FFP in exchange for mileage credits accumulated under the program, including the following:

- The ability to buy a ticket at a discount
- Upgrades
- Free companion tickets
- Free travel on a participating airline
- Other nontravel awards

3.104 The extent of the marketing benefits to be obtained from an FFP by the sponsoring airline depends partly on the airline's ability to handle the extra traffic generated by the FFP while not displacing fare-paying passengers. As a result, as FFPs have developed, it has become more commonplace for airlines to impose restrictions involving, for example, the limitation of capacity that is available for frequent flyer passengers on some or all flights, including, in particular, those during peak travel periods on high density routes.

3.105 There are two methods of accounting for free or discounted travel arising under FFPs: the incremental cost method and the deferred revenue method. There is no specific authoritative accounting guidance on the accounting for FFPs. FASB previously considered but reached no consensus on the accounting for FFPs. Although certain aspects of frequent flyer accounting have been governed by the principles set forth in SAB No. 104 (primarily related to the sale of FFP credits, as discussed later in this chapter), other aspects have simply evolved as a matter of industry practice. Over the years, airlines have used both methods and provided certain disclosures concerning FFPs. In the absence of any specific authoritative guidance, many airlines have analogized to the guidance in either FASB ASC 605-50 to support use of the incremental cost method, or FASB ASC 605-25, to support use of the deferred revenue method.

3.106 Under the deferred revenue method, an airline recognizes a liability for the issuance date selling price (in accordance with FASB ASC 605-25-25) of all outstanding mileage credits, regardless of how they originated. In contrast, under the incremental cost method, an airline recognizes a liability under a mixed model comprised of an incremental cost accrual for mileage credits not sold to third parties and expected to be redeemed for travel on the airline, the selling price of mileage credits sold to third parties (that is, deferred revenue), and the cost of settlement for mileage credits not sold to third parties and expected to be redeemed for travel on a partner airline or a nontravel award.

3.107 The deferred revenue method is acceptable in all circumstances, whereas the incremental cost method is acceptable in only certain circumstances. For example, the incremental cost method is inappropriate in circumstances in which (*a*) a significant number of paying passengers are displaced by passengers redeeming awards[3] or (*b*) the value of an individual award is significant compared with the value of the purchase(s) earning the award.

Incremental Cost Method

3.108 Historically, there has been substantial industry practice to use the incremental cost method rather than the deferred revenue method. The incremental cost method is based on the concept that FFP awards are tightly controlled so that passengers redeeming the awards are simply filling excess capacity and, as a result, the carrier is incurring only the incremental cost of providing what would have otherwise been an empty seat. However, FinREC believes if FFP awards are without limitations (such as capacity restrictions or blackout dates) or if special promotional programs are used that could cause the value of an individual award to be significant compared to the value of the purchase(s) earning the award, use of the incremental cost method may be inappropriate.

3.109 Under the incremental cost method, a liability is recorded for the incremental cost associated with rewarding those FFP members expected to redeem mileage credits. For awards expected to be redeemed for free travel on the sponsoring airline, incremental cost typically includes the cost of fuel, food and drinks, ticketing, and certain types of insurance because these are the typical incremental costs an airline will incur to provide travel to one additional passenger. For awards expected to be redeemed for free travel on other airlines or for nontravel awards, the incremental cost is the amount the sponsoring airline will be obligated to pay the other airline (see the "Accounting for Interline Mileage Credits" section of this chapter for additional guidance) or other third-party providing the award.

3.110 A key factor in estimating an FFP obligation under the incremental cost method is the estimate of mileage credits that are expected to be redeemed. In practice, that estimate is influenced by a number of factors, including the following:

- The threshold of mileage credits required before an FFP member can secure an award and the mix of award redemptions under the FFP. The rate of redemption will be affected by the ease with which members can accumulate sufficient mileage credits to make a redemption and the attraction of the awards offered by the FFP.
- The expiration/purge period, if any, established for the program. Some FFPs provide that mileage credits must be used within a specified period or they are lost. The rate of redemption of mileage credits will be affected by the airline's policy for credits lost through expiration or nonuse.
- The airline's redemption experience. Airlines develop statistics including
  - — overall number of mileage credits redeemed.

[3] For purposes of applying the guidance discussed in this guide, the fact that a passenger redeeming an award might otherwise have been a paying passenger had they not redeemed the award should not lead to the conclusion that a paying passenger has been displaced by a passenger redeeming an award. In other words, passengers redeeming an award do not displace themselves as paying passengers for purposes of applying the guidance discussed in this guide.

— proportion taken in air (including air travel provided by airline partners) and nonair travel awards.

— flight segments against which awards are taken.

— nature of other awards taken.

— frequency of redemptions.

— utilization of mileage credits among particular member categories.

3.111 Some airlines with well established programs and comprehensive redemption data have been able to build up experience-based statistical models for estimating the likelihood and type of redemptions.

3.112 The cost of offering nonair travel awards is the cost charged to the airline for the product. Airlines need to accumulate sufficient data regarding the level of mileage credits redeemed for nonair travel awards to be able to properly estimate their obligation for nonair travel awards.

Deferred Revenue Method

3.113 Under the deferred revenue method, the selling price of all mileage credits, including those granted for travel on the issuing airline, is deferred until such time as the mileage credits are used for an award. Historically, there has been limited use of the deferred revenue method, although some airlines have adopted it in connection with business combinations or upon application of fresh start accounting when exiting bankruptcy. However, the deferred revenue method is required under International Financial Reporting Standards (IFRS). Accordingly, in addition to guidance provided in this chapter, if an airline deems it necessary to refer to IFRS, an airline may also give consideration to International Financial Reporting Interpretations Committee Interpretation No. 13, *Customer Loyalty Programmes*, when applying the deferred revenue method.

3.114 Therefore, in determining the selling price of mileage credits, airlines first need to determine if vendor-specific objective evidence (VSOE) of selling price is available.

3.115 The industry generally has looked to transactions involving the transportation element of sales of mileage credits to third parties (such as other airlines) to derive VSOE of selling price. If such transactions are not representative of VSOE of selling price, airlines may look to purchased tickets with the same or similar restrictions as frequent flyer awards.

3.116 The selling price of mileage credits is determined at issuance of the credits and the resulting liability is not adjusted, or *marked-to-market*, for future changes in selling price. However, as the selling price of mileage credits issued changes over time it is necessary to change the initial deferral rate, which results in a pool of mileage credits valued at different rates. Because mileage credits are frequently fungible and therefore airlines have difficulty in tracking individual mileage credits from issuance to usage for a flight or other award, airlines generally adopt a methodology to determine the value of mileage credits used for awards. A common approach is to use a weighted average or first-in, first-out method, much like an inventory valuation, to determine which miles are used for redemptions and which remain in the pool of outstanding miles.

3.117 Mileage credits that expire under the terms of the airline's policy or not likely to be redeemed are collectively referred to as *breakage*. The estimation and accounting for the breakage of mileage credits is a critical accounting consideration. FinREC believes that breakage should be recognized using one of the following methods:

- *Expiration recognition method*. Breakage is recognized at expiration of the mileage credits, or, if mileage credits do not expire, when the likelihood that the mileage credits will ever be redeemed for future services becomes remote.
- *Redemption recognition method*. Breakage is estimated and recognized in proportion to actual mileage redemptions.

3.118 Immediate recognition of breakage is not appropriate. FinREC believes that an airline's breakage methodology should be based on company-specific historical evidence of customers' redemption rates and should be applied consistently.

3.119 The estimation of the breakage rate will frequently require the use of sophisticated statistical modeling techniques to analyze historical information. Typically, the models will take into account historical behavior such as the number of mileage credits accumulated and the frequency and size of redemptions. Also, customer characteristics, such as geographic location and length of time in the program, would need to be considered. It is necessary to consider carefully whether historical redemption behavior is indicative of expected future behavior by reference to such factors as changes in the terms of the program or the customer population or goods or services offered. In particular, the following factors may affect the estimated rate:

- Changes in the popularity of the program over the years, with many new members joining, such that the redemption history relating to the older years is no longer representative.
- Customers who have rarely or never redeemed mileage credits, building up their balance for redemption for a highly valuable award or future travel, thus making their historical redemption activity not representative of their future activity.
- Differing patterns in the redemption rates relating to such factors as the age of customers, their geographical locations, their past buying pattern, the length of time as a customer, or other factors that may indicate that population may need to be segmented into different groups for the purpose of estimating future redemptions.
- Requirements for customers to build up to a minimum level of mileage credits before they can reach an award level, which may mean a number of customers will not be able to redeem their mileage credits.
- The expiration/purge period, if any, established for the program. Some FFPs provide that mileage credits must be used within a specified period or they are lost. The redemption rate will be affected by any systematic elimination of unused mileage credits.

3.120 The assumptions and models used to estimate the breakage rates need to be reasonable, reliable, and objectively determined.

Accounting for Mileage Credits Sold to Third Parties

3.121 FASB ASC 605-25-25 provides the most appropriate guidance for accounting for the sale of mileage credits to nonairline participants. Paragraphs 1–2 of FASB ASC 605-25-25 explain the criteria for determining whether arrangements with multiple deliverables should be divided, how to measure and allocate the arrangement among the separate units of accounting based on specific criteria as described in FASB ASC 605-25-25-5, that the allocation should be based on their relative selling prices, and that the applicable revenue recognition criteria should be considered separately for separate units of accounting.

3.122 Under FASB ASC 605-25-25, the airline would, if possible, separate the component of the sale representing the value of the future travel awards (the travel component) from the component that represents the value associated with other goods or services acquired by the nonairline participant, such as the right to use the airline's database or customer mailing list (the marketing component).

3.123 The marketing component may be recognized as revenue at the point of sale of the mileage credits to the affinity partner, whereas the travel component is recognized as travel occurs.

3.124 For airlines accounting for their FFPs under the deferred revenue method, the selling price of the travel component is determined based on the same rate used for mileage credits granted for travel on the issuing airline, as discussed in paragraph 3.117, and recognized as revenue using the same methodology selected by the airline pursuant to paragraph 3.116.

3.125 For airlines accounting for their FFPs under the incremental cost method, the selling price of the travel component is typically derived in the same manner as the selling price of mileage credits under the deferred revenue method. Also, because airlines generally do not track miles on a specific identification basis (that is, miles awarded for flying are not distinguished from those sold to nonairline participants), airlines accounting for their FFPs under the incremental cost method have developed conventions for allocating mileage credits used between those granted for travel on the issuing airline (an incremental cost model) and those sold to nonairline participants (a deferred revenue model). This convention assumes that the mileage credits sold to nonairline participants are used for travel awards, and thus recognized as revenue, on a straight-line basis over the historical usage period of the mileage credits. In applying this concept, an airline needs to eliminate from its incremental cost liability the mileage credits sold to nonairline participants for which revenue is deferred.

3.126 FinREC recommends that revenue attributed to the marketing component be classified as other operating revenue and that revenue attributed to the travel component be classified as passenger revenue.

Accounting for Interline Mileage Credits

3.127 Airlines frequently include other airline partners in their FFPs to extend their programs in order to attract and retain certain premium passengers as well as to offer their FFP members extended options for the potential use of their accumulated mileage credits. In most of these cases, the airline also participates in the other airline's FFP on a reciprocal basis. Such cross-participation by airline partners in each other's FFP creates a number of accounting issues for airlines accounting for their FFPs under the incremental cost method that stem primarily from the settlement of usage under the contracts between the carriers. The majority of contracts call for settlement of the net activity between the 2 carriers' FFPs—generally, at least annually—at a stated rate per mileage credit that is frequently higher than the carriers' own incremental cost to provide an FFP seat. In fact, these rates are frequently up to 10 times higher than the incremental cost rate because they tend to represent the mileage credit equivalent of the fair value of a restricted ticket. For airlines accounting for their FFPs under the deferred revenue method, these issues are generally not present because deferral rates approximate or exceed the settlement rates.

3.128 In the early stages of these partner relationships, many airlines accounted for interline FFP activity on a net basis. Individual activities were not recorded; rather, the net result of the settlement was recorded as income or expense in the period of settlement. FinREC believes that gross-basis accounting is the appropriate practice.

3.129 Following is an illustration of the accounting for interline FFP activity for an airline using the incremental cost method. In this illustration, four activities affect the settlement between Home Airline (HA), the reporting entity, and Partner Airline (PA).

- *a.* Home Airline FFP members earn mileage credits in the Home Airline FFP for travel that occurred on Partner Airline. Partner Airline is obligated to pay Home Airline for the mileage credits earned.
- *b.* Home Airline FFP members use mileage credits to fly on Partner Airline. Home Airline is obligated to pay Partner Airline for the seats provided to Home Airline FFP members by Partner Airline, generally at a converted award level.
- *c.* Partner Airline members earn mileage credits in the Partner Airline FFP for flights on Home Airline. Home Airline is obligated to pay Partner Airline for the mileage credits earned.
- *d.* Partner Airline FFP members use their mileage credits to fly on Home Airline. Partner Airline is obligated to pay Home Airline for the seats provided to the Partner Airline FFP members by Home Airline. The seat cost from Home Airline is generally at a converted award level.

3.130 The following table summarizes the accumulation of the net settlement of the program and the accounting for the previously described activities on a gross basis.

Activity No.	*Activity*	*Effect on Settlement*	*Miles*	*Assumed Settlement Rate per Mile (cents per mile)*	*Net (Payment) Receipt by HA*	*Treatment Under Gross-Basis Accounting by HA*
1.	HA earn on PA	PA pay HA	240,000,000	0.01	$2,400,000	Deferred revenue
2.	HA burn on PA	HA pay PA	440,000,000	0.01	(4,400,000)	Frequent flyer liability
3.	PA earn on HA	HA pay PA	172,000,000	0.01	(1,720,000)	Operating expense
4.	PA burn on HA	PA pay HA	772,000,000	0.01	7,720,000	Current revenue
	Amount due from PA				$4,000,000	

Activity 1. The payment received from Partner Airline is treated as deferred revenue and is recognized as travel occurs as discussed in the "Accounting for Mileage Credits Sold to Third Parties" section of this chapter. The accounting for this activity is consistent with the accounting for all other sales of mileage credits to third parties. Assuming that Home Airline's historical usage period is 3 years, $2,400,000 of deferred revenue would be amortized over 3 years, which would result in recognition of $800,000 of revenue in year 1 in addition to $7,720,000 of revenue resulting from activity 4.

Activity 2. The payment to Partner Airline represents a settlement of the existing Home Airline FFP liability and is offset against it. This transaction would have no effect on Home Airline revenue or expense. See paragraphs 3.130–.131 for further discussion.

Activity 3. The payment is recorded by Home Airline as an operating expense to reflect the cost to purchase these mileage credits from the Partner Airline FFP.

Activity 4. This represents passenger revenue to Home Airline.

3.131 FinREC recommends that activities 1 and 4 be included in passenger revenue (with respect to activity 1, upon amortization of the deferred revenue), that activity 2 be offset against the frequent flyer liability, and that activity 3 be recorded as an operating expense.

3.132 In this illustration, activity 2 results in the settlement of a portion of Home Airline's existing FFP liability by paying another carrier to provide transportation to one of its FFP members. Frequently, the contracts between partner airlines call for settlement rates that are substantially higher than the incremental cost that would be incurred by the sponsoring airline. FinREC believes that if a carrier that uses the incremental cost method expects to settle a portion of its FFP awards with travel on other airlines at rates that are substantially higher than the incremental cost that it would incur to provide that travel itself, that fact needs to be considered in estimating the airline's FFP liability. In substance, this is similar to valuing the liability for the cost of nonair travel awards that will be purchased by the airline to satisfy a portion of its FFP awards.

3.133 Airlines evaluate the effect of the anticipated settlement of their FFP liability on other airline partners in different ways. The most prevalent approach is to use the airline's recent history to estimate a historical pattern of FFP liability settlements by travel on partner airlines, to use that historical pattern to estimate the portion of outstanding FFP awards that will be settled with travel on partner airlines, and to value that portion of the liability based on the settlement rates contracted with its airline partners. FinREC recommends that when an airline enters into a contract with a new partner, it accrues the additional liability based on the airline's best estimate of the portion of its FFP awards that will be settled on the new partner airline. Factors to consider in making that estimate include the contractual terms of the agreement with the new partner airline, the practical limitations on the number of frequent flyers who can reasonably redeem free travel awards on the new partner airline, the airline's expectations and forecasts developed for use in negotiating the agreement, and the potential effect on awards redemptions on other partner airlines as a result of the new agreement. FinREC believes it would be inappropriate to not accrue a liability upon entering into a contract with a new partner due to a lack of historical experience with that particular airline.

Changes in Estimates Related to FFPs

3.134 The accounting for the various aspects of an airline's FFP is complicated and involves a large number of estimates and assumptions. Some of the more significant assumptions include the type and value of the incremental costs components, estimates of how frequent flyer obligations will be settled (for example, by providing service or paying to a third-party airline to settle the obligation), the selling price of the undelivered element in the sale of a mileage credit, and the period over which sold mileage credits will be used by members when not tracked on a specific identification basis. An airline needs to document the basis for its key estimates and assumptions used in accounting for its FFP. However, given the nature and significance of many of these estimates and assumptions, it is common to have changes in assumptions and estimates that affect the recorded amounts of the obligations or deferred revenues. Also, the appropriateness of these estimates needs to be reassessed on a regular basis. The frequency of this reassessment will depend on the sensitivity of the estimate to change. Changes in estimates should be accounted for in accordance with the provisions of FASB ASC 250-10-45-17 which states that a change in accounting estimate should be accounted for in the period of change if the change affects that period only or in the period of change and future periods if the change affects both. A change in accounting estimate should not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

3.135 Changes in FFP-related estimates that affect the calculation of the FFP liability generally affect the period in which the change occurs, whereas changes in estimates related to revenue recognition on the sale of mileage credits and related deferred revenue components generally affect both the period in which the change occurs and future periods and should be accounted for prospectively as a component of the amount and timing of revenue recognition on the sale of mileage credits. The following table provides some examples of common changes in estimate in frequent flyer accounting and how each could be evaluated under the accounting provisions of FASB ASC 250-10-45.

Frequent Flyer Program Common Changes in Estimate	*Period of Accounting Recognition*
• Changes to estimates of incremental cost	• Current period charge or credit to operations to reflect the updated estimate of the obligation or liability
• Changes to the settlement rate or portion of mileage credits to be used on other airline partners	• Current period charge or credit to operations to reflect the updated estimate of the obligation or liability
• Changes in the selling price of the deferred component of the sale of mileage credits	• Applied prospectively to future sales of mileage credits with respect to the initial recognition
• Changes in the period over which mileage credits sold are expected to be used by program members to claim travel	• Applied prospectively to future sales of mileage credits and any unamortized deferred revenue balances

Prepurchase of Mileage Credits

3.136 As part of their scheduled airline service, most airlines operate a loyalty program featuring airline mileage and other travel credit or awards issued under cobranded credit card programs. Recently, airlines have looked to these cobranded credit card programs as an additional source of financing. To protect the credit card issuers in the event an airline goes into bankruptcy, the underlying financing arrangement can be structured as a prepurchase of mileage credits by the credit card issuer to be used for fulfillment of awards offered to cardholders. Prepurchased miles are recorded as either deferred revenue or indebtedness by the airline based on the terms of the arrangement in accordance with the guidance provided in FASB ASC 470-10-25. When the credit card issuer grants mileage credits to its customers, deferred revenue or debt is reduced and the credit, if possible, is separated between the travel component and the marketing component and accounted for pursuant to paragraph 3.119.

Disclosures

3.137 See chapter 7 for disclosure considerations related to FFPs.

Capacity Purchase Agreements Gross Versus Net Presentation

Background

3.138 Regional jet contracts between a mainline airline and a regional airline are typically structured as capacity purchase agreements. Under these contracts, the mainline carrier purchases the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the mainline airline. The mainline airline also takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. There are a number of variations of capacity purchase agreements, including cost-plus formulas, fee-per-departure formulas, capacity-based formulas, and block-hour-based formulas, to name a few. Ultimately, these formulas achieve a similar outcome, which is to cover the regional airline's costs and provide a margin. Mainline carriers use capacity purchase agreements because these arrangements allow them to expand their operations at lower fixed costs by using the regional's lower cost structure for operating jet aircraft. The mainline airline can also benefit from capacity purchase agreements because they enable the airline to better control its entire network of flights and serve strategic routes that might otherwise be uneconomical. See chapter 9 for a more detailed discussion of capacity purchase agreements.

Presentation

3.139 To determine whether revenue from capacity purchase agreements should be reported on a gross basis (passenger or other transportation revenue reflects the ticket revenue, whereas the capacity purchase payments are reflected as operating expenses) or on a net basis (capacity purchase payments to the regionals are charged to passenger revenue), FinREC believes that mainline carriers should first analyze the capacity purchase agreement under FASB ASC 840-10-15. FinREC believes that revenue from capacity purchase agreements that contain a lease under FASB ASC 840-10-15 should be presented on a gross basis whereas agreements that do not contain a lease should be further analyzed under FASB ASC 605-45-45, to determine whether gross or net presentation is appropriate.

Inherent Risk Factors

3.140 Factors that influence inherent risk related to revenue recognition, advance ticket sales, receivables, interline payables, and FFPs might include the following:

- The volume of sale and transportation transactions is immense, requiring sophisticated IT systems.
- Certain airlines have very complex ticket pricing structures that result in numerous price changes, which can affect key revenue accounting estimates.

- The interline process requires significant estimation and can take up to 24 months for certain situations to resolve fully.
- Processing of lifted coupons has been outsourced by many airlines.
- Not all sales and use documents result in matching, necessitating a level of estimation in recording revenues.
- Although interline transactions need to be accounted for on a gross basis, they are often settled on a net basis and may be inappropriately recorded that way.
- Not all lifted coupons are matched to sales information, resulting in unmatched usage and revenue breakage.
- There is a high degree of manual involvement in accruals, refunds, and the interline process.
- The frequent flyer arrangements between airline partners can be very complex.

Chapter 4

Acquiring and Maintaining Property and Equipment

Background

4.01 The airline industry is capital intensive, with a significant portion of an airlines assets invested in property and equipment. An airline's property and equipment consist of three primary categories: flight equipment, ground property and equipment, and equipment under capital leases. The total cost recorded by an airline for purchased property and equipment includes all expenditures applicable to its acquisition. These include the manufacturer's sales price, sales or use tax, duty, freight costs, and the cost of any additions or modifications that qualify for capitalization.

4.02 Flight equipment generally consists of aircraft, rotable parts, and leasehold improvements. Work-in-progress accounts used to accumulate costs qualifying for capitalization are also classified as part of flight equipment. An aircraft's airframe and engines usually are accounted for as separate assets, primarily due to the interchangeability of engines among airframes. Airlines generally classify flight equipment as either operating or non-operating. Operating flight equipment includes all items in use in air transportation services or in services related to air transportation. Aircraft undergoing overhaul, modification, or repair or held for standby use as a spare (ready for immediate use as backup) remain in the operating accounts. Additionally, airlines typically include progress payments on flight equipment purchase contracts made to aircraft manufacturers as part of property and equipment. As part of the aircraft purchase agreement, airlines frequently provide some of the interior to the manufacturer for use in the assembly process, referred to as *buyer-furnished equipment* (BFE). BFE typically includes seats, galleys, overhead bins, in-flight entertainment systems, and other equipment that the airline uses to provide customer service. This equipment may be accounted for separately due to airlines tendency to replace these assets during the life of the aircraft.

4.03 Ground property and equipment generally consist of land, buildings, leasehold improvements (such as those made to passenger and cargo terminals), and equipment (including equipment used to service aircraft and traffic loads on airport ramps and in terminals; to maintain flight and ground properties; and to conduct sales, training, and other office functions).

4.04 Airlines account for ground property and equipment in a manner similar to other industries. Therefore, this chapter focuses primarily on the accounting for flight equipment, which, due to its unique nature, poses certain accounting issues that are not encountered in other industries. This chapter also includes a discussion of leases and other financing structures historically used by the airline industry to finance aircraft, airport facilities, and other assets because these structures often have unique accounting issues. Finally, because airlines operate in a heavily regulated environment, especially with respect to maintenance of their aircraft and related flight assets, this chapter touches on accounting issues and policies related to maintaining owned and leased aircraft, an area in which, historically, there has been significant diversity in practice.

4.05 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 835-20 establishes standards of financial accounting and reporting for capitalizing interest cost as part of the historical cost of acquiring certain assets. The historical cost of acquiring an asset includes the cost necessarily incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.

4.06 In accordance with the requirements of FASB ASC 835-20-05-1, the interest cost attributable to progress payments on aircraft purchase contracts and many construction projects should be capitalized as part of the cost of the asset and disclosed in accordance with FASB ASC 835-20-50-1.

Fleet Strategy

4.07 Aircraft fleet and capacity growth are significant, ever-changing fundamentals for airlines. An airline's fleet plan must consider a number of factors, including the number of fleet types an airline has and the age and mission of the aircraft.

4.08 The number of aircraft types in a fleet is an important decision that can affect many aspects of an airline's operating expenses. For example, an airline with a limited number of aircraft types can reduce maintenance costs because mechanics need to be knowledgeable on fewer aircraft, and spare parts requirements are reduced. Labor expenses can also be reduced because training costs are lower, and both crew and aircraft scheduling tend to be more efficient. From a capital expenditures standpoint, an airline may benefit from larger volume discounts from a supplier if it is ordering large quantities of only one aircraft type.

4.09 The age of the aircraft is important from an operating efficiency perspective because a younger fleet tends to be more fuel-efficient and to require less maintenance than an older fleet. Fuel efficiency is important because fuel is one of the largest operating costs of an airline. Depending on their maintenance accounting policy (for example, expense-as-incurred, deferral, or built-in overhaul, as discussed in the "Expense Recognition" section of this chapter), airlines with a young fleet may have a built-in maintenance holiday, whereby their overall maintenance costs start low, particularly during the periods prior to the initial scheduled maintenance of the fleet, and then increase as the fleet ages, the warranties provided by the aircraft manufacturers expire, and scheduled maintenance activities commence.

4.10 The size of the aircraft serving a particular market is equally important because airlines attempt to match supply with demand. An aircraft that is too large for the market that it serves would lead to empty seats, which decreases revenue per available seat mile (an important measure of the revenue productivity of an airline). Typically, airlines use large, wide-body aircraft for international markets with fewer frequencies and smaller, narrow-body aircraft and regional jets in domestic markets.

Owned Property and Equipment

Aircraft Modifications

4.11 Historically, airlines have undertaken major programs to modify interior configurations of aircraft—including the reconfiguration and replacement of customer service-related assets such as seats, galley equipment, in-flight entertainment systems, and storage bin space—typically in response to market forces and passenger demands.

4.12 FASB ASC 908-360-25-1 states that if the modifications of interior configurations of certain aircraft types enhance the usefulness of the aircraft, the costs associated with the changes should be capitalized. FASB ASC 908-360-35-3 explains that airframe modifications should be depreciated over the estimated useful life of the aircraft or the modifications, whichever is less. FASB ASC 908-360-40-1 states that 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.

4.13 An aircraft consists of multiple components that may be replaced independently as part of a modification before the aircraft reaches the end of its useful life. For the replacement to be capitalized, the net carrying amount of the replaced part should be charged to expense in the current period. Additionally, an airline may need to consider whether to accelerate depreciation if a part will be replaced in a future period.[1] Although replacement of an aircraft component often denotes an identical part, this term is interpreted more broadly. Replacement of a component occurs if a part is functionally replaced by another component, regardless of whether the replacement component is identical to the replaced component. A replacement component could, for example, be a higher quality component that performs the same function as the replaced component, or an equal-quality, lower-cost component performing the same function. Additionally, one component consolidating two functions could replace two components, or two components highly specialized in function could replace a single component. The costs of modifications that do not qualify for capitalization are expensed as incurred. Also, for modifications performed after an aircraft has been placed into service, the cost of any maintenance performed concurrently with a modification is not capitalized as part of the modification but rather is separated and accounted for in accordance with the airline's maintenance accounting policy.

4.14 Airlines modify their fleets continuously. At times, these modifications result in new functionality. For example, an airline could decide to add Internet access voluntarily or be mandated to add ground-to-air missile guidance tracking systems by the Federal Aviation Administration (FAA). These kinds of modifications are accomplished over time (during overnight or scheduled maintenance to avoid taking the aircraft out of revenue service) and ultimately result in the retrofit of the existing fleet. Eventually, the specifications are revised for new aircraft deliveries so that the aircraft will be delivered with

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[1] Airlines need to periodically evaluate their experience with replacements. If an airline has a history of replacing certain parts before the parts are fully depreciated, the Financial Reporting Executive Committee believes it should consider assigning shorter useful lives to those parts.

the new functionality. The AICPA Financial Reporting Executive Committee (FinREC) believes that such modifications meet the criteria for capitalization.

4.15 Airlines also receive Airworthiness Directives (ADs) from the FAA or similar mandatory equipment changes from regulators in other countries in which they operate. ADs require the airline to perform modifications or additional inspections and checks or install additional equipment on existing aircraft. Costs associated with ADs are either capitalized as flight equipment or accounted for as maintenance based upon whether the expenditure qualifies for capitalization. Generally, the costs of ADs that add functionality or parts that were not on the original aircraft qualify for capitalization. Examples include collision avoidance systems and pilot door improvements. However, the existence of an AD requiring an airline to perform a particular modification does not result in automatic capitalization of such costs, absent the evaluation of the AD under guidance provided in this section.

4.16 The cost of painting aircraft subsequent to placement of the aircraft into service is charged to expense when incurred.

Manufacturer Incentives

4.17 Airlines frequently negotiate purchase and other incentives with flight equipment manufacturers whereby, as an inducement to purchase a particular manufacturer's aircraft, engine, parts, or other flight equipment, the manufacturer will grant credits or other incentives to the airline. These incentives can take many forms and may include credits for products such as additional aircraft, spare parts, or other equipment or for services such as flight crew training, maintenance, advertising, promotions, and aircraft financing.

4.18 The price of the aircraft is allocated to the aircraft and purchase incentives on a relative fair value basis at the time of delivery of the aircraft or other underlying purchase or when the services or other incentives are delivered, whichever is earlier. Frequently, incentives are items that are sold separately by the manufacturer, such as spare parts, training, aircraft simulators, and other equipment. Although some incentives may not have established prices (for example, favorable financing or other services), their fair value can generally be determined by using available market information. The fair value of the incentive is recognized separately and accounted for based on its nature with an offsetting reduction to the cost of the aircraft or other underlying purchase. For example, if the aircraft manufacturer provides crew training to the airline, the fair value of the training is recognized as an asset, to the extent it represents a service not yet rendered, with an offsetting reduction in the purchase price of the aircraft. The asset is then charged to expense as the training is provided. Accounting for incentives in this manner properly reflects their usage, which is independent of the usage of the aircraft or other underlying purchase following its delivery.

4.19 If the underlying contract is for multiple aircraft or engines, the incentives may be issued disproportionately to the aircraft or engines covered by the contract. Regardless of when the credits are issued, the total credits to be received need to be allocated proportionately to the contractually committed aircraft or engine deliveries.

4.20 Purchase incentives received for aircraft or equipment in leasing arrangements are accounted for similarly. For incentives received on aircraft under operating leases, a deferred credit is recognized and amortized over the lease term on a straight-line basis as a reduction of aircraft rent expense or included in any gain or loss.

4.21 FASB ASC 908-360-55-1 states that the credit received as a purchase incentive from an aircraft manufacturer to induce a purchase of that manufacturer's aircraft should be applied as a reduction of the purchase price for the aircraft that is owned or under a capital lease, or, in the case of an aircraft under an operating lease, amortized over the life of the related aircraft.

4.22 Sometimes manufacturers provide incentives that increase based upon the number of aircraft ordered and that can apply to aircraft already delivered. FASB ASC 605-50-25-10 provides accounting guidance for those situations.

4.23 These incentives, which can result in increased rebates or refunds, should be recognized as a reduction to the cost of the aircraft or other underlying purchase as the aircraft are delivered, provided the amounts are probable and reasonably estimable. According to FASC ASC 605-50-25-10, if the incentives are not probable and reasonably estimable, they should be recognized as the milestones are achieved.

4.24 FASB ASC 605-50-25-11 indicates that any of the following factors may impair the ability to determine whether manufacturer incentives are probable and reasonably estimable:

- The incentive relates to purchases that will occur over a relatively long period.
- There is an absence of historical experience with similar products or the inability to apply such experience because of changing circumstances.
- Significant adjustments to expected incentives have been necessary in the past.
- The asset to which the incentive applies is susceptible to significant external factors (for example, technological obsolescence or changes in demand).

4.25 Subsequent changes in the estimated incentives to be achieved are changes in estimate that should be recognized using a cumulative catch-up adjustment in accordance with FASB ASC 605-50-25-12. That is, the airline would adjust the cumulative balance of the incentives recognized to the revised cumulative estimate immediately.

4.26 For marketing purposes, when a new aircraft or engine model is developed, the manufacturers may have to induce their launch customer by granting more purchase incentives than would otherwise be granted for a well established model. It is important for the manufacturers to have an established customer base for the product in order to market it to others. These incentives can take the form of traditional credits, or they can contain more sophisticated features, such as being contingent upon how many units of the model the manufacturer sells to others. The accounting for these and other incentives should reflect their purpose, which most likely is to reduce the cost of the related aircraft.

4.27 Manufacturers also will periodically issue credits for purposes other than the original acquisition of an aircraft or fleet. In evaluating the accounting for these additional credits, only credits issued by manufacturers directly as a result of the failure of aircraft or equipment to meet guaranteed performance thresholds or warranties may, in some circumstances, be recognized directly in results of operations as a reduction of the expense the guarantee or warranty relates to. The general premise is that credits issued to an airline as compensation for a short term performance issue that is subsequently corrected are recognized as a reduction to expense, whereas credits issued for longer term performance issues are accounted for as a reduction in the cost basis of the aircraft because the airline has, in effect, paid less for a lower performing asset. For credits that are issued at a time other than upon the initial acquisition of the aircraft and are accounted for as a reduction in the cost basis of the aircraft, FinREC believes that an airline can either adjust depreciation, amortization, or rent expense solely on a prospective basis or record a cumulative catch-up adjustment to the appropriate expense caption computed as though the asset had been initially recorded at the reduced cost basis, based on the policy elected by the airline that should be applied consistently. Prospective accounting is supported by FASB ASC 250-10-50-4, whereas the cumulative catch-up treatment is supported by FASB ASC 605-50-25-12.

4.28 An example of a credit memo issued to support the equipment's long term performance is a credit memo issued as an incentive to enter into an extended maintenance contract. This credit memo would be recognized over the remaining life of the maintenance contract. This incentive is recognized when issued and is amortized over the remaining life of the contract.

Liquidated Damages

4.29 Liquidated damages (frequently referred to as *late delivery fees*) are contractual payments made to an airline by an aircraft or equipment manufacturer due to the nondelivery of an aircraft or equipment by a stated delivery date. The amount is generally specified in the asset purchase agreement and is negotiated to represent compensation for an airline's lost revenue associated with the delay in the delivery of an aircraft or equipment. Generally, liquidated damages are received prior to the delivery of the aircraft and have historically been accounted for as revenue.

4.30 FinREC believes liquidated damages should be accounted for in accordance with the guidance set forth in Technical Questions and Answers (TIS) section 2210.28, "Accounting for Certain Liquidated Damages" (AICPA, *Technical Practice Aids*), under which liquidated damages are typically recorded as a reduction of the cost of the asset and, therefore, reduce depreciation on a prospective basis. Amounts of liquidated damages in excess of the total cost of the asset would be recognized by the airline as income.

Advanced Delivery Deposits and Capitalized Interest

4.31 Aircraft manufacturers usually require progress payments to be made several months, and even years, prior to the delivery of ordered aircraft. Traditional aircraft purchase contracts require a minimal initial deposit at signing of the contract for each firmly committed aircraft ordered and then payments at various intervals prior to the scheduled delivery date of the aircraft (for example, 24, 18, and 6 months prior to scheduled delivery). The payments are generally a predefined percentage of the aircraft cost and can represent the advance payment of up to approximately half of the aircraft's delivery cost. The advanced delivery deposits are also known as *purchase deposits* and are intended to help the manufacturer finance a portion of the aircraft construction costs. Advanced delivery deposits are qualifying assets, and interest related to these payments should be capitalized as part of the cost of the aircraft until the aircraft has been delivered and is ready for its intended use and appropriate disclosures should be made. Please refer to the "Depreciation" section in this chapter for a discussion of when depreciation of aircraft, including capitalized interest, should begin.

4.32 Changes in passenger demand and the effects of certain geopolitical events can cause airlines to reduce capacity or alter their capacity plans for future years. One of the ways an airline can reduce capacity is to either defer or cancel orders of aircraft. In the case of a delivery deferral, the progress payments made by the airline to the manufacturer generally remain on deposit and available for use against future deferred or committed deliveries, although the manufacturer may require the airline to forfeit deposits or pay penalties in consideration for agreeing to the deferral. Deposits are generally not refundable. As such, if the cancellation or deferral results in significantly more deposits with the manufacturer than necessary for firmly committed aircraft, the recoverability of the deposits, including related capitalized interest, should be evaluated in accordance with FASB ASC 360-10-35-34.

4.33 In the event of an aircraft order deferral, consideration should be given to FASB ASC 835-20-25-3, which states that capitalization of interest should continue as long as all three criteria set forth in that paragraph are present, including "activities that are necessary to get the asset ready for its intended use are in progress." Accordingly, if an aircraft delivery is deferred for a significant period, expenditures for the aircraft have been made and interest costs continue, the carrier may need to evaluate whether the asset is still being prepared for its intended use and whether it is appropriate to continue capitalization of interest.

4.34 Frequently, contracts contain provisions requiring the airline to forfeit its progress payments or pay a penalty, or both, in case of cancellation of aircraft on order. In practice, however, the airline will often negotiate with the aircraft manufacturer so that the penalty is waived and only a portion of progress payments, if any, is forfeited; although, FinREC recommends that an airline carefully evaluate the substance of such agreements to determine if any provisions in them represent penalties. The penalty, if any, is generally recognized as an operating expense. FASB ASC 420-10-25 provides guidance on determining the appropriate timing of recognition for any penalties associated with cancellation of aircraft on order.

4.35 FASB ASC 420-10-25-12 states that a liability for costs to terminate a contract before the end of its term should be recognized when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty).

4.36 An airline may also need to evaluate the recoverability of associated purchase deposits and related capitalized interest. Generally, if purchase deposits are forfeited, such amounts, including related capitalized interest, are charged to operating expense as a component of the contract termination costs. Likewise, if the advance delivery payment is refunded, the capitalized interest would be reversed.

Developmental and Pre-operating Costs

4.37 Development costs include costs related directly to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and any expenses of regulatory proceedings. Pre-operating costs include costs related directly to adding a new aircraft type to an airline's fleet, such as flight crew training, maintenance training, pre-revenue flight expenses, insurance, and depreciation.

4.38 FASB ASC 720-15-25-1 states that costs of start-up activities, including organization costs, should be expensed as incurred.

4.39 Pre-operating costs related to the integration of new types of aircraft and developmental costs (other than advertising costs) are required to be expensed as incurred.

4.40 Advertising costs should be accounted for in conformity with the guidance in FASB ASC 720-35-25-1, which states that advertising costs should be expensed either as incurred or the first time the advertising takes place. The accounting policy selected from these two alternatives should be applied consistently to similar kinds of advertising activities.

Used Aircraft

4.41 Used aircraft are acquired in various conditions and at various times between overhauls.

4.42 FASB ASC 835-20-05-1 provides that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.

4.43 Therefore, FinREC believes that costs incurred by the airline for items such as interiors, painting, customer service equipment, and maintenance to bring the aircraft current and to conform the aircraft to an airline's maintenance program prior to placing the aircraft or engine into service should be capitalized as a cost of preparing the asset for service. Similar to newly purchased aircraft, interest cost related to the acquisition of used aircraft should be capitalized until the aircraft is ready for its intended use as specified under FASB ASC 835-20-05-1. However, FinREC believes once an aircraft is placed into service, any subsequent costs should be accounted for according to its substance.

Impairment of Long-Lived Assets

4.44 Airlines frequently decide to either decrease capacity by removing certain aircraft from service on a temporary or permanent basis or, for strategic reasons, to realign their fleets with a new mix of aircraft. The airline's fleet plan is the primary source of information on the planned number of aircraft for the airline and includes information about new aircraft deliveries, anticipated retirements, and temporary groundings.

4.45 Aircraft can be removed from active service temporarily until they are needed to support operations. Temporarily grounded aircraft are parked and stored but are intended to be returned to service in the future. Temporarily grounded aircraft are treated like operating aircraft, and depreciation or rental expense continues to be recognized.

4.46 Capacity decisions or changes in fleet structure can dictate that aircraft are no longer needed in the fleet. Permanently grounded aircraft are aircraft that will never return to active revenue service.

4.47 FASB ASC 360-10-45 provides guidance on the treatment of assets that are to be held and used, held for sale, or to be disposed of other than by sale. FASB ASC 360-10-45-9 states that assets that are to be disposed of by sale should be accounted for as held for sale only if they meet all of the following criteria:

- Management, having the authority to approve the action, commits to a plan to sell the asset.
- The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets.
- An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated.
- The sale of the asset is probable and the transfer of the asset is expected to qualify for recognition as a completed sale, within 1 year, with some limited exceptions to the 1-year requirement provided in FASB ASC 360-10-45-11.
- The asset is being actively marketed for sale at a price that is reasonable in relation to its current value. The price at which a long-lived asset is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset. A market price that is reasonable in relation to fair value indicates that the asset is available for immediate sale, whereas a market price in excess of fair value indicates that the asset is not available for immediate sale.
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

4.48 An aircraft would generally have to be permanently grounded in order to meet the definition of *held for sale* because the complexity of fleet movements and scheduling make it unlikely that an aircraft in service would meet the definition of *available for immediate sale*. Aircraft classified as held for sale should be recorded at the lower of carrying amount or fair value less the cost to sell. The difference between carrying amount and fair value less the cost to sell should be recognized as an impairment charge in the period that the aircraft meets the held-for-sale criteria. FinREC believes that such impairment charges should be included in operating income for both operating and nonoperating aircraft. No further depreciation or amortization should be recorded on an aircraft that is classified as held for sale. Changes in the fair value less the cost to sell should be recognized as gains or losses in the period of change, and the asset's carrying amount should be adjusted for both increases and decreases, provided that the asset's carrying amount does not exceed its carrying amount as of the date the aircraft was classified as held for sale.

4.49 Any aircraft that does not meet the criteria of held for sale is considered held and used until the asset is disposed of. Under the requirements of FASB ASC 360-10-35-21 a long-lived asset (or assets grouped at the lowest level of identifiable cash flows) should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

4.50 FASB ASC 360-10-35-17 states that an impairment loss should be recognized only if the carrying amount of a long-lived asset (or asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (or asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (or asset group). That assessment should be based on the carrying amount of the asset (or asset group) at the date it is tested for recoverability, whether in use or under development. An impairment loss should be recognized for the amount by which the carrying amount of a long-lived asset (or asset group) exceeds its fair value. Such impairment losses should be included in operating income, per FASB 360-10-45-4.

4.51 The following table summarizes the different accounting models and treatments for nonoperating aircraft once the aircraft are either temporarily or permanently grounded by an airline.

Disposition Status	*Accounting Treatment*	*Timing of Accounting*
Temporarily Grounded	Continue to depreciate and consider the need to complete a held for use impairment analysis	Date of Decision
Permanently Grounded—Held for Sale (this also includes aircraft to be disposed of by sale of usable parts)	Stop depreciation and conduct a held for sale impairment analysis	Date of Grounding[1]
Permanently Grounded—Abandon	Stop depreciation and write down to salvage value	Date of Grounding[1]
In-Service—Decision made to market aircraft for sale or abandon at a fixed date	Held for use impairment analysis—accelerate depreciation to estimated salvage value at planned disposal date[2]	Date of Decision

[1] An impairment indicator would most likely occur prior to the actual grounding.

[2] Aircraft still in operation for an airline will not meet held-for-sale criteria unless use of the aircraft is extremely limited (for example, being used as spare aircraft and not actively scheduled).

4.52 At the point a decision is made to permanently ground an aircraft that is not intended to be sold and, therefore, does not meet the held-for-sale criteria of FASB ASC 360-10-45-9, FinREC believes that an impairment evaluation should be performed. In addition to the possible impairment charge, the remaining depreciable life and salvage value of the aircraft should be adjusted to reflect the last expected in service date. Once removed from service, a permanently grounded aircraft is classified as a long-lived nonoperating asset and no longer depreciated (at that point the aircraft should be fully depreciated to its salvage value). Furthermore, a permanently grounded aircraft that is not intended for sale may be stripped of usable parts. These usable parts from such aircraft are recorded in rotable parts at their fair value, with the aggregate value of the parts not to exceed the carrying amount of the aircraft at the time it was permanently grounded. In the event the fair value of the individual parts exceeds the carrying amount of the aircraft, the carrying value of the aircraft is allocated to the parts based on their relative fair values.

Impairment Indicators

4.53 The following are examples of events or changes in circumstances that may indicate impairment:

- Disposal or planned disposal of an entire fleet or a major portion of a fleet
- Management's commitment to permanently ground a fleet (or a major portion of a fleet) that is currently operating
- Significant fleet plan changes, including new aircraft orders
- Operational downsizing
- Adverse changes in the way the aircraft are being used, affecting cash flows (for example, significant reductions in fleet-wide aircraft utilization rates)
- Permanent and significant declines in fleet fair values
- Significant changes in the anticipated time period that a fleet will be used by the airline
- Significant changes in cash flows
- Regulatory changes and requirements that affect an airline's ability to operate its aircraft

4.54 When an asset group (for example, a fleet of aircraft) is tested for recoverability, it also may be necessary to review estimates of remaining useful lives and salvage values of those aircraft, regardless of whether an impairment is recognized.

4.55 Changes in depreciation from changes in estimated remaining useful lives or salvage values should be recognized prospectively, in accordance with FASB ASC 250-10-45-17.

Cash Flows

4.56 A long-lived asset or assets should be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities, per FASB ASC 360-10-35-23.

4.57 Identifying the group of assets at which cash flows are largely independent requires judgment; however, most passenger airlines have concluded that each aircraft type (and potentially each aircraft model) provides largely independent cash flows. When making the determination of how to group aircraft and related fleet assets (that is, rotable parts, leasehold improvements, and expendable parts that are used by a particular fleet and are considered part of the asset group; see the "Related Fleet Assets" section of this chapter for further discussion) for impairment testing, airlines consider whether a particular fleet depends on another fleet for connecting traffic (for example, a short haul flight feeds traffic to longer haul connecting flights) and whether it is necessary to combine those fleets for impairment testing. Although cash flows for specific aircraft may be obtainable, it is generally not practical to evaluate cash flows at this level due to the interchangeability of aircraft in an airline's operations, unless the aircraft is not interchangeable with other aircraft in the airline's fleet. Cargo airlines cash flows are typically assessed at the network level due to the significant integration of the short haul and long haul cargo operations. Regional carriers' cash flows may be assessed at a contract level as the regional carrier's contract with the major airline may be the lowest level of identifiable cash flows.

4.58 Estimates of future cash flows include all future revenues expected to be collected net of costs expected to be paid. This is generally accomplished using data from an airline's route profitability system, which allocates revenue to flights based on prorated fares or some other metric and expenses based on the nature of the expense and, if necessary, an allocation basis (such as available seat miles and passengers boarded). For passenger airlines, earnings can include the effects of both downstream and upstream revenues (for example, the value of connecting passengers on a short haul flight that feeds traffic to longer haul connecting flights) and include onboard passenger revenue, onboard cargo revenue, and other in-flight revenue. If an airline elects to use upstream and downstream revenue in its analysis, it would need to show consistently that total revenue to all flights does not exceed total external revenues from operations. Variable costs associated with the operation of the aircraft include items such as fuel, passenger variable expense, cargo variable expense, direct capacity expense, and variable overhead (training, ramp services, and line maintenance). Fixed costs include items such as aircraft rent, maintenance facilities, and station rent. Undiscounted cash flow assumptions are further adjusted to reflect the effect of future events, such as planned fleet changes, projections of passenger yield, anticipated fluctuations in the market price of jet fuel, labor costs, and other relevant factors in the markets in which the fleet operates.

4.59 When a fleet comprises both owned aircraft (including aircraft under capital leases) and aircraft under operating leases, fleet level cash flows include the full ownership cost of the leased aircraft (that is, the full operating rent expense, which includes both capital cost and financing cost), whereas for owned aircraft and related fleet assets, only the capital cost are assessed for recoverability. As a result, cash flows for the entire fleet will be determined, inclusive of the rental payments for leased aircraft, and compared to the carrying value of the assets in the asset group (that is, owned aircraft and related fleet assets) in the impairment assessment, under FASB ASC 360-10-35. If the carrying value of assets in the asset group exceeds the sum of the expected future cash flows, then the airline should measure the fair value of the fleet to determine whether to recognize an impairment loss on any or all of the assets in the asset group. Under FASB ASC 360-10-35-28 an impairment loss will reduce only the carrying amounts of the owned aircraft and related long-lived fleet assets in the asset group (expendable parts would be included in the asset group, but they would not be subject to impairment because they are not long-lived assets; see the "Related Fleet Assets" section in this chapter). The loss should be allocated to the owned aircraft and related long-lived fleet assets in the asset group on a pro rata basis using the relative carrying amounts of the assets, except that the loss allocated to an individual asset should not reduce the carrying amount of each asset below its fair value whenever that fair value is determinable without undue cost and effort.

4.60 For example, group all assets related to a fleet type level (for example, B767-300ER and related fleet assets) and then estimate future cash flows based on earnings projections over the remaining operating life of the fleet. One way to perform this analysis is to select a representative base year (generally using the most recent history) and determine the earnings and expenses of the fleet in that base year. This net earnings amount becomes the basis for projecting future cash flows for each subsequent year the fleet will be in operation, factoring in the effects of the events noted previously, such as aircraft retirements and additions. The sum of future undiscounted cash flows over the life of the primary asset in the asset group (in this case, the owned fleet assets), inclusive of the rental payments for any leased B767-300ER aircraft, is then compared to the carrying value of the owned B767-300ER aircraft and related assets in the fleet. If the owned assets' carrying value exceeds the sum of the expected future cash flows, then the airline will measure the fair value of these assets to determine whether to recognize an impairment loss on any or all of the long-lived assets in the fleet.

Fair Value

4.61 The fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions, as discussed in FASB ASC 820-10-35-3.

4.62 The determination of fair value should consider attributes specific to the asset; for example, the condition or location, or both, of the asset and any restrictions on its sale or use. A fair value measurement assumes the transaction to sell the asset occurs in the principal market for the asset or, in the absence of a principal market, the most advantageous market for the asset. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available. However, because quoted market prices are often not available for used aircraft, the best information available should be used to estimate fair value, including published sources and independent appraisals based on long-term use assumptions. Prices from distress sales or forced liquidations or values obtained as part of a debt financing arrangement are not representative of fair value; however, they may be considered in conjunction with other market indicators. Airlines may also want to review recent and proposed transactions, such as sales of similar aircraft and engine types, when publicly available.

Recognition of Impairment

4.63 Assets evaluated for impairment under the held-for-use criteria, whose carrying amount is determined to be not recoverable and exceeds their fair value, should be written down to their fair value, which should be used as the new cost basis to continue to depreciate the aircraft over their remaining useful lives. Salvage values may also need to be reevaluated in light of newly determined fair value.

Related Fleet Assets

4.64 When an airline tests its fleet for impairment as discussed in the "Cash Flows" section in this chapter, it includes the carrying value of the related rotable parts, leasehold improvements, and expendable parts that are used by the particular fleet as part of the asset group. For example, if certain rotable parts can only be used on the primary aircraft in the asset group, then an impairment analysis would include these assets as discussed in FASB ASC 360-10-15.

4.65 Although expendable parts would be included in the asset group, they would not be subject to impairment (because they are not long-lived assets). However, they may be subject to net realizable value considerations if there will be excess or obsolete parts as a result of fleet-related changes that triggered the impairment evaluation. Please see the "Spare Parts" section in this chapter for definitions and descriptions of rotable and expendable parts.

Leased Property and Equipment

4.66 The aircraft leasing market over the years has diversified into a sophisticated financial market, resulting in a number of complex leasing structures used by airlines to finance or refinance aircraft acquisitions. An important driver in an airline's evaluation of a particular leasing structure is its tax status because many aircraft leasing structures are designed to transfer tax benefits to the lessor from the airline. Such benefit is then reflected in the lease rate received by the airline. Examples of some of the leasing structures used by the industry are

- leasing directly from a leasing company.
- leasing from the aircraft manufacturer or an affiliate.
- public or private equipment trust certificates (ETCs). Typically in these transactions, the aircraft is placed in a trust with an equity participant (other than the airline) and the trust issues debt to public or private parties to fund the remainder of the acquisition of the aircraft, which is then leased back to the airline (alternatively, the agreement between the trust and the airline can be structured as debt).
- publicly or private enhanced equipment trust certificate (EETC) structures. These structures are initially the same as ETCs except that additional series of trusts are involved to modify the cash flows in order to provide for a number of credit ratings to improve the overall creditworthiness of the debt securities issued by the equipment trust. Depending on how the third-party investment is structured, EETCs generally result in either debt or an operating lease from the airline's perspective.

4.67 All leases should be classified as either capital or operating in accordance with FASB ASC 840-10-25. Many complex leasing structures, however, may involve a variable interest entity (VIE). Depending on the structure of the arrangement, the equipment trusts in the ETC and EETC structures are generally VIEs and, as a result, the guidance in FASB ASC 810-10-15 should be considered prior to the application of FASB ASC 840-10-25-1 to the lease. For example, if the trust in an ETC or EETC leasing structure is a VIE and the airline is the primary beneficiary, then the trust would be consolidated by the airline, eliminating the need to evaluate the lease between the trust and the airline under FASB ASC 840-10-25-1. See chapter 6, "Other Accounting Considerations," of this guide for further discussion of VIEs. Airlines should also evaluate whether ETC and EETC structures are subject to the sale-leaseback provisions of FASB ASC 840-40. An airline should carefully review this guidance when determining whether a lease should be classified as capital or operating. Classification of subleased equipment is determined in the same manner as for other leases.

4.68 Once a lessee has the right to use or control physical access to the leased property, if an operating lease, regardless of whether the leased property has been placed in service, the lease term has commenced and rent expense should be recognized according to FASB ASC 840-20-25-11, which states that rental costs associated with ground or building operating leases that are incurred during a construction period should be recognized by the lessee as rental expense.

4.69 Rental cost applies to both new and used aircraft as well as ground facilities and equipment. According to FASB ASC 840-20-25-1, rental expense should be recognized on a straight-line basis over the lease term unless another systemic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used.

4.70 Some airlines provide the crew, fuel, maintenance, and other services necessary to operate the flight, along with the leased aircraft, to other airlines, in what is referred to as a *wet lease* arrangement.

4.71 FASB ASC 840-10-15-17 states that if an arrangement contains a lease as well as other nonlease elements, the classification, recognition, measurement, and disclosure requirements of FASB ASC 840, *Leases*, should be applied to the lease element of the arrangement by both the purchaser and the supplier.

4.72 Per FASB ASC 840-10-15-18, other elements of the arrangement not within the scope of FASB ASC 840-10-25-1 should be accounted for in accordance with other applicable generally accepted accounting principles (GAAP). FASB ASC 840-10-15-19 provides further guidance regarding the treatment of payments and other consideration called for by the arrangement.

Leasehold Improvements

4.73 A *leasehold improvement* is a permanent improvement or betterment that increases the usefulness of the leased property and will generally revert to the lessor at the end of the lease term. Airlines typically make improvements or modifications to leased aircraft. These costs need to be evaluated to determine if they qualify for capitalization as leasehold improvements. In capitalizing leasehold improvements, future maintenance or replacement events may need to be considered. As discussed in the "Depreciation" section in this chapter, airlines may account for certain flight equipment separately from the related aircraft because the assets have useful lives that are different from the life of the aircraft. Consistent with the letter that the Office of the Chief Accountant of the Securities and Exchange Commission (SEC) sent to the AICPA Center for Public Company Audit Firms on February 7, 2005,[2] in which the SEC staff expressed its views regarding certain operating lease accounting matters and their application under U.S. GAAP, leasehold improvements should be amortized over the lesser of the useful life of the improvement or the lease term, in accordance with FASB ASC 840-10-35-6. Additionally, when new leasehold improvements are capitalized, the unamortized balance of any previous leasehold improvements is evaluated to determine if they have been replaced and, therefore, should be written off.

4.74 Much like for owned assets, an airline may incur costs after taking delivery of a leased aircraft to get the aircraft ready for its service to the airline. For new aircraft, these costs are frequently minimal and generally relate to certain BFE or other airline-specific equipment modifications. Capital asset additions installed on newly leased assets are capitalized as leasehold improvements. Modifications to used aircraft that will be leased are likely to be more extensive and will frequently include additional costs to bring the aircraft current and to conform the aircraft to an airline's maintenance program, interiors, painting, and other customer service equipment. These items, if incurred by the lessee, may qualify for capitalization as leasehold improvements.

4.75 FASB ASC 840-20-25-11 requires recognition of rent expense once a lessee has the right to use regardless of whether the leased property has been placed in service.

4.76 Lessors sometimes provide incentives or allowances under an operating lease, which may include funding or reimbursing the lessee for the cost of leasehold improvements. Consistent with the SEC staff letter on operating leases (see paragraph 4.73), any such incentives should not reduce the leasehold improvements, but should be recognized as reductions of rental expense by the lessee on a straight line basis over the term of the new lease, in accordance with FASB ASC 840-20-25-6.

4.77 Therefore, leasehold improvements are recorded at their full cost, regardless of who paid for them. The nonauthoritative publication TIS sections 5600.16, "Landlord Incentive Allowance in an Operating Lease," and 5600.17, "Cash Flows Statement Presentation of Landlord Incentive Allowance in an Operating Lease" (AICPA, *Technical Practice Aids*), provide additional guidance on accounting for operating lease incentives.

Return Conditions

4.78 Aircraft lease agreements often contain provisions that require an airline to return aircraft airframes and engines to the lessor in a certain maintenance condition or pay an amount to the lessor based on the airframe and engine's actual return condition. Typically, an aircraft is expected to be returned at "half time," which presumes that at least 50 percent of the eligible flight time since the last overhaul remains when the aircraft is returned to the lessor. Generally, there are 3 ways an airline can satisfy its obligations under such leases: (*a*) performing maintenance (either internally or by contracting a third-party service provider) to return the aircraft to the level of maintenance required by the contract, (*b*) paying cash to compensate the lessor if the aircraft is returned with less flight time remaining than specified under the lease,

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[2] This letter is available on the Securities and Exchange Commission website at www.sec.gov/info/accountants/staffletters/cpcaf020705.htm.

and (*c*) swapping owned components (or other leased components) for leased components (engines).

4.79 Return conditions should be considered in the airline's policy of accounting for overhauls. The effect will vary according to the maintenance accounting method used and the terms of the individual lease agreements. The objective is to avoid having either unamortized overhaul costs or an unneeded accrual on the books when the aircraft is returned. Unamortized overhaul costs are amounts capitalized under either the deferral or built-in overhaul methods of accounting for aircraft maintenance that have not been fully amortized to expense at the time the aircraft is returned to the lessor. FinREC believes lease return costs should be accounted for in a manner similar to the accounting for contingent rent. The objective is to recognize the expense for lease return costs as the related aircraft hours accumulate, beginning when it is probable that such costs will be incurred and they can be estimated. The specific methods used to achieve this objective depend on the circumstances.

4.80 FinREC believes, due to the nature of these agreements, incurrence of lease return costs becomes probable and the amount of those costs can typically be estimated near the end of the lease term (that is, after the aircraft has completed its last maintenance cycle prior to being returned). Because it is presumed that the lessee would select the most economical way to satisfy its obligation, FinREC believes that the amount the airline should recognize as a contingent rent expense is the lesser of (*a*) the contractual cash settlement to the lessor in accordance with the terms of the lease or (*b*) the estimated cost of the major overhaul. FinREC believes that in situations in which the airline would receive a refund from the lessor if the eligible flight time remaining since the last overhaul was in excess of the minimum lease return condition required by the lease, the amount of the refund, if any, should be considered in the measurement of the contingent rent expense. That is, assuming an airline has determined it is probable that lease return costs would be incurred, the lesser of the estimated net payment (payment for maintenance less the portion anticipated to be received from lessor) or lease return costs (assuming the maintenance was not performed) would be accrued over the remaining term of the lease. However, an airline would not record a receivable from the lessor in the event a net refund is anticipated. Often, an airline will choose to satisfy lease return conditions by swapping engines as part of its overall engine maintenance program. FinREC believes that a lease return liability would not need to be accrued if an airline has the intent and ability to satisfy lease return conditions through swapping engines, and if those swaps lack commercial substance (refer to FASB ASC 845, *Nonmonetary Transactions*).

4.81 FASB ASC 845-10-25-1 states that a reciprocal transfer of a nonmonetary asset should be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset, such that the usual risks and rewards of ownership of the asset are transferred.

4.82 However, if it is concluded that the swaps have commercial substance, FinREC believes that a lease return liability would need to be accrued. If the airline uses either the deferral or built-in overhaul method of accounting for planned major maintenance activities, unamortized maintenance would be written off when the engine is swapped.

Maintenance Deposits

4.83 Under the terms of most aircraft lease agreements, the airline, as lessee, is legally and contractually responsible for maintenance and repair of the leased aircraft throughout the lease term. However, in order to financially protect the lessor in the event the airline does not properly maintain the aircraft, some aircraft lease agreements include provisions that require the airline to make deposits with the lessor (frequently referred to as *maintenance reserves* or *supplemental rent* in the lease agreements). These amounts are typically calculated based on a performance measure, such as flight hours or cycles, and are contractually required to be reimbursed to the lessee upon the completion of the required maintenance of the leased aircraft. If there are sufficient funds on deposit to reimburse the airline for the maintenance incurred by the airline, the lessor reimburses the airline for the maintenance. However, reimbursement is generally limited to the available deposits associated with the specific maintenance activity, and the lessors are not financially obligated to any outside maintenance providers. Regardless of whether there are available reimbursable deposits, the airline remains legally responsible for maintaining the leased aircraft throughout the lease term pursuant to the applicable provisions of the leases. Finally, some of the lease agreements provide that if there are excess amounts on deposit at the expiration of the lease, the lessor is entitled to retain such excess amounts, whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the airline.

4.84 Maintenance deposits are accounted for as assets when any excess amounts on deposit at the end of the lease are refundable to the lessee. FASB ASC 840-10-25-39B addresses how lessees should account for maintenance deposits that are refunded only if the lessee performs specified maintenance activities. Payments made that are less than probable of being refunded by the lessor at inception of the lease are not considered maintenance deposits within the scope of FASB ASC 840-10-25-39A, which states that if at lease inception a lessee determines that it is less than probable that the total amount of payments will be returned to the lessee as a reimbursement for maintenance activities, the lessee should consider that when determining the portion of each payment that is not within the scope of FASB ASC 840-10-25-39B and FASB ASC 840-10-35-9A.

4.85 FASB ASC 840-10-25-39B states that maintenance deposits paid by a lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be accounted for as a deposit asset.

4.86 FASB ASC 840-10-35-9A states that a lessee should evaluate whether it is probable that an amount on deposit recognized under FASB ASC 840-10-25-39B will be returned to reimburse the costs of the maintenance activities incurred by the lessee. When an amount on deposit is less than probable of being returned, it should be recognized as additional expense. When the underlying maintenance is performed, the maintenance costs should be expensed or capitalized in accordance with the lessee's maintenance accounting policy.

4.87 If an airline is required to return an aircraft to the lessor in a certain condition at the end of the lease term, the airline will need to evaluate other U.S. GAAP for when (and if) to record a liability related to the return condition requirement. (See the "Return Conditions" section of this chapter for more information.)

Lease Termination

4.88 Terminating aircraft operating leases early or permanently ceasing operations of aircraft financed under operating leases commonly occurs in the airline industry. FASB ASC 420-10 provides guidance on recognition and measurement of costs associated with terminating an operating lease and the reporting and disclosure of such costs.

4.89 FASB ASC 420-10-25-1 states that a liability for a cost associated with an exit or disposal activity should be recognized in the period in which the liability is incurred (except for one-time employee termination benefits). In the unusual circumstance in which fair value cannot be reasonably estimated, the liability should be recognized initially in the period in which fair value can be reasonably estimated.

4.90 In the case of ceasing operations of a leased aircraft, a liability for costs that will continue to be incurred under the lease for its remaining term without economic benefit to the airline should be recognized and measured at fair value when the airline ceases using the aircraft, which is generally the point when the aircraft is permanently removed from operations. The fair value of this liability should be determined based on the remaining lease rentals, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. A present value technique is often the best available valuation technique with which to estimate the fair value of such liability.

4.91 Accretion of the liability should be recorded as an expense, as required by FASB ASC 420-10-35-4.

4.92 In the case of early termination, a liability for costs to terminate the lease (for example, a termination penalty) shall be recognized and measured at its fair value when the airline terminates the lease in accordance with its terms (for example, when the airline gives written notice to the lessor within the notification period by the contract or has otherwise negotiated a termination with the lessor). Disclosure would be appropriate if the decision to terminate has occurred, but the conditions for accrual have not yet been met.

4.93 Paragraphs 11–15 of FASB ASC 420-10-55 illustrate how to calculate costs associated with terminating an operating lease.

Capacity Purchase Agreements

4.94 Certain agreements between regional airlines and their major airline partners that stipulate for the regional to provide aircraft capacity to the major are considered leases pursuant to FASB ASC 840. Generally, just the aircraft portion of a capacity purchase agreement would qualify as a lease under FASB ASC 840. The provisions of the regional capacity purchase agreement should be evaluated under FASB ASC 840 when the arrangement provides for specific aircraft acquisition reimbursements to the regional airline. Chapter 9, "Regional Airlines," discusses criteria that need to be considered when determining whether a capacity purchase agreement contains a lease. The lease portion of the capacity purchase agreement should be accounted for and classified in accordance with FASB ASC 840. Additionally, as discussed in chapter 6, capacity purchase agreements with regional airlines should be evaluated under FASB ASC 810-10-15 to determine if they cause the regional airline to be considered a VIE.

Depreciation

General

4.95 The objective of depreciation accounting is to allocate the cost of a capital asset over its expected useful life in a manner that best represents the pattern of consumption of the expected benefits. Some airlines have begun accounting for certain flight equipment, primarily customer service assets such as seats and in-flight entertainment equipment, separately from the related aircraft because those assets have lives that are different from the life of the aircraft. Airlines can use any depreciation method permitted by U.S. GAAP that reflects the pattern of consumption of the asset being depreciated, although the most prevalent in the industry is the straight-line method. Generally, a depreciation method applied on an operating measure such as flight hours would not be appropriate because it would allow suspension of depreciation of temporarily grounded aircraft. An airline may change its depreciation method only if the new depreciation method is justifiable on the basis that it is preferable. For example, an entity that concludes that the pattern of consumption of the expected benefits of an asset has changed and determines that a new depreciation method better reflects that pattern may be justified in making a change.

4.96 FASB ASC 250-10-45-18 requires that a change in depreciation method be accounted for as a change in accounting estimate that is effected by a change in accounting principle. The FASB ASC glossary defines a *change in accounting estimate effected by a change in accounting principle* as a change in accounting estimate that is inseparable from the effect of a related change in accounting principle. An example of a change in estimate effected by a change in principle is a change in the method of depreciation, amortization, or depletion for long-lived, nonfinancial assets.

4.97 Depreciation begins when the asset is placed in service, which generally coincides with the date when the asset is ready for its intended use. Depreciation continues until the asset is permanently removed from service. If an aircraft is temporarily out of service (temporarily grounded) due to labor strikes, lack of traffic, maintenance, or other reasons, depreciation of the aircraft would continue. If an airline commits to a plan to permanently ground an asset before the end of its previously estimated useful life but continues to operate the asset, depreciation estimates should be revised. and the asset should be depreciated over its shortened useful life, per the guidance of FASB ASC 360-10-35-44.

4.98 However, the asset may be subject to an impairment charge as a held-for-use asset if anticipated undiscounted cash flows over the estimated life are less than the carrying amount of the asset (refer to the "Impairment of Long-Lived Assets" section in this chapter for a discussion of impairment). Aircraft to be held and used for which an impairment loss has been recognized should be accounted for at its new cost (fair value), with depreciation recognized over the asset's remaining useful life.

4.99 FASB ASC 360-10-35-43 states that an asset that meets the held-for-sale criteria is not depreciated.

4.100 Airlines' fixed assets that have significant unit costs and are comparatively few in number, such as aircraft, engines, and other identifiable assets, are generally depreciated on an individual basis. Rotable parts may be depreciated on a pooled basis as discussed in the following section.

Depreciation of Rotable Parts

4.101 Rotable parts that are fairly homogeneous and significant in number may be depreciated on a pooled basis.[3] Under this method, depreciation is recorded based upon a pool of similar assets. Because these parts typically support one fleet type, they are generally pooled according to the fleet they support (issues surrounding the classification of rotables and other spare parts are discussed in the "Spare Parts" section of this chapter). The pool is then depreciated over the remaining life of the fleet. This is done by taking the cost of the assets in the pool and subtracting out the salvage value and the accumulated depreciation to arrive at the remaining depreciable basis. The remaining depreciable basis is then divided by the remaining life of the applicable fleet to arrive at depreciation expense for the period. Also, when these parts are scrapped, either because they are beyond economic repair or lost, the cost of the scrapped asset is written off against the accumulated depreciation for the fleet type. The fleet life is calculated from the date that the first aircraft was put into service through the anticipated fleet retirement date.

Estimated Useful Life and Salvage Value

4.102 The period over which an asset is depreciated (its estimated useful life) and its estimated salvage value are determined on the basis of many factors. Aircraft are maintained in relatively the same condition throughout their service lives; therefore, property and equipment are replaced primarily because of market growth, technological developments, operating cost efficiency, and revenue-generating capability. Because such factors may affect each airline in a different way, different airlines often have different estimated useful lives for the same type of equipment. Salvage values for the same type of equipment also vary among airlines for the same reason. The determination of aircraft lives and salvage values also varies according to each entity's projections of when the aircraft will be replaced, its ability to finance replacements, length of flights, number of takeoffs and landings, and similar factors affecting the cost of maintaining aircraft in flying condition. The lives of certain parts can vary from the original airframe life. For example, aircraft interiors, in-flight entertainment equipment, and other customer service related assets may be separately depreciated over a shorter life than the aircraft to which they relate due to frequent updating or changes to such equipment. As discussed in the "Aircraft Modifications" section of this chapter, if an airline has a history of replacing such parts before they are fully depreciated, FinREC believes the airline should consider assigning separate shorter useful lives to those parts. In general, the salvage values for aircraft range from 0 percent to 20 percent of original cost, depending on the age of the fleet, industry usage trends, and technological advances.

4.103 Ground assets consist of ramp equipment, furniture, and other miscellaneous office equipment. The lives for these types of assets also vary

[3] Please note that this depreciation method, as described in this guide, is different from a method known as the *group-life method* of accounting that is applied to large groups of homogeneous assets and primarily used in the utility, telecommunications, and railroad industries.

among air carriers. In general, the industry assigns zero salvage values and lives ranging between 2 and 15 years for these types of assets.

Amortization of Leasehold Improvements

4.104 Consistent with the SEC staff letter on operating leases (see paragraph 4.73), leasehold improvements should be amortized over the lesser of the useful life or the lease term. The nonauthoritative publication TIS sections 5600.14, "Amortization/Depreciation of Leasehold Improvements in an Operating Lease (Part 1)," and 5600.15, "Leasehold Improvements and Lease Term in an Operating Lease (Part 2)" (AICPA, *Technical Practice Aids*), provide additional general guidance for lessees on determining the period over which to amortize leasehold improvements.

4.105 Airlines execute leases with airport authorities for use of the gates, terminals, landing rights, and other operating needs. At some airports, lease terms are often month to month, or on a shorter term basis, and do not contain renewal provisions. The practice of using shorter term leases is often due to the airports experience with bankrupt carriers for which underutilized long-term airport leases at favorable terms were a key asset controlled by bankrupt carriers and were, therefore, outside the control of the airport authority. Additionally, given the complexity of airport leases, carriers may be on a month to month lease during the negotiation period of a new longer term lease. As a result of this practice, close examination is necessary to determine the lease term, as provided in the FASB ASC glossary.

Airport leases differ from traditional commercial leasing relationships in several ways, including the following:

- An airline has no choice but to execute a lease at the airport with the airport authority. If the airport authority has a desire to keep the lease at 30 days, that is solely in its prerogative to do so. There are no alternative facilities in which the airline can operate (that is, there is no similar retail space down the street).
- Airports are run by governmental entities (generally affiliated with the local city or county government or a separately established airport governmental authority). These entities are generally not-for-profit entities that pass their cost to the users of the airport.
- The FAA regulates the right for U.S. domestic airlines to fly between any two cities in the United States, and under the Airline Deregulation Act of 1978, a domestic airline may choose to fly between any two cities in the United States (subject to slot restrictions at a few airports).
- Although an airline will typically execute various agreements of varying terms with an airport authority, ultimately, as a result of various federal regulations, an airport authority legally may not restrict use of its airport to an airline. By accepting federal money, airports have covenanted to the FAA that the airport will be open to all carriers on "reasonable conditions without unjust discrimination" (*Transportation, U.S. Code* 49, Section 47107(a)(1)). The Department of Transportation and FAA have stated in interpretation of this law that preventing or impeding "a carrier's service at an airport is inconsistent with the airport's contractual grant

assurances to provide reasonable and not unjustly discriminatory access to the airport and not to grant an exclusive right at the airport" (*Airport Business Practices and Their Impact on Airline Competition*, FFA/OST Task Force Study (October, 1999), p. 13). Airlines believe this legal interpretation effectively prevents the airport authority from terminating the rights of the airline to operate at the airport as long as the airline continues to choose to operate at the airport. Under this statute, the airline has to be provided access to equivalent space to conduct its existing operations.

- No history exists where an airline has been removed from its space at an airport location at the expiration of its lease, absent its choice to leave, or except in cases where the airport authority has determined that the space is underutilized and has taken action to recover underutilized space from the airline.
- Airlines have a long history of operating at airports on short-term leases without stated renewal rights that have, in effect, renewed continuously. In addition, although an airline may be asked to share its space (especially if it is underutilized) or, in rare cases, move space at an airport to another location, this happens very infrequently. Historically, if an airline is asked to move to accommodate another airline, the other airline would normally compensate the moving carrier for its costs, including leasehold improvement costs that may not otherwise be recovered.

4.106 Based on the factors described in the preceding paragraph, airlines have concluded that a legal right exists for the airlines to stay at the airport past their contractually stated lease term. Despite the existence of a stated lease term, the airlines believe the airport authority cannot legally enforce the lease terms and remove the airline from the airport facility unless the facility is being underutilized by the airline. Therefore, the airlines have, in substance, renewal options to remain at the airport past the stated lease term. In such situations, FinREC believes it is appropriate to have an amortization period in excess of the stated contractual term (but no longer than the useful life of the leasehold improvement) if all of the following criteria are met:

- The airline reaches a supportable legal conclusion that the rights granted to the airlines by the FAA or the appropriate international aviation authority under the law legally prevent the airport authority from removing the airline from its operations upon expiration of the stated contractual lease term, except in circumstances where the facilities are underutilized, which results in the airline's ability to continue and renew the lease at its discretion.
- The renewal is reasonably assured, because failure of the airline to exercise its rights to these renewals would impose a significant economic penalty on the airline.
- Substantially equivalent space is not available for the airline's use at another location at the airport.

4.107 If the criteria described in paragraph 4.106 are met, the reasonably assured renewals would be included in the lease term in determining the period over which to amortize the leasehold improvements.

Aircraft Maintenance

4.108 The FAA or other regulatory agencies have established repair and overhaul cycles for each airframe and engine part in an effort to prevent potential hazards and to ensure transportation safety. Maintenance is performed after an aircraft is placed into service to keep it operating.

4.109 FASB ASC 908-10-05-6 states that maintenance requirements are dictated by the highly sophisticated nature of the industry's equipment. The timing and extent of maintenance procedures are determined by individual airlines using studies based on actual experience, which demonstrate airworthiness to the FAA or other regulatory agencies. Maintenance may be provided in-house, which requires maintenance facilities outfitted with specifically designed equipment.

4.110 An airline's maintenance program includes three general categories: line maintenance, component overhaul and repair, and maintenance checks. Line maintenance consists of routine daily and weekly scheduled maintenance inspections and checks, including preflight, daily, overnight, and weekly checks, and any diagnostics and routine repairs. Some or all of these activities may be outsourced by the airline to a third-party provider.

4.111 Component overhaul and repair involves the repair of parts, including engines, landing gear, and avionics, that are either repaired in-house or sent to third-party FAA-approved maintenance repair stations. Overhauls encompass all inspections or replacements of major parts, which the FAA requires at specific maximum periodic intervals to recertify that the part is completely airworthy. However, an overhaul does not include the cost of routine replacement of minor parts and servicing or inspection of airframes and aircraft engines. Also excluded from overhauls are costs accounted for as restoration of assets, such as extraordinary costs associated with the renewal of major structural parts beyond the scope of normal periodic overhauls, and other costs with a life span similar to the depreciable service life of the related airframe or aircraft engine.

4.112 Maintenance checks consist of more complex inspections and servicing of the aircraft that cannot be accomplished during an overnight visit. These occur at predetermined levels as set forth in an airline's maintenance program and can range in duration from a few days to approximately a month, depending on the magnitude of the work prescribed in the particular check. Planned major maintenance activities or major overhauls of engines are all part of this category.

Expense Recognition

4.113 The cost of line maintenance and other routine repairs, whether performed by the airline or outsourced to a third-party provider, is expensed as incurred. However, there are three acceptable methods of accounting for planned major maintenance activities performed under established programs for regulatory compliance related to different fleet types and for engines, airframes, or major components of the same aircraft type. FASB ASC 908-360-25-2 states that air carriers shall adopt an accounting method that recognizes overhaul expenses in the appropriate period. This may result in different methods for different aircraft, as well as different methods of airframe overhauls and engine overhauls. These methods are described in the following paragraphs.

4.114 *Expense as incurred method.* Under this method, all maintenance costs are expensed in the period incurred because maintenance activities do not represent separately identifiable assets or property units in and of themselves; rather, they serve only to restore assets to their original operating condition.

4.115 *Deferral method.* Under this method, the actual cost of each planned major maintenance activity is capitalized and amortized to expense in a systematic and rational manner over the estimated period until the next planned major maintenance activity.

4.116 *Built-in overhaul method.* Under this method, costs of activities that restore the service potential of airframes and engines are considered a component of the asset. This method cannot be applied to leased aircraft. The cost of airframes and engines (upon which the planned major maintenance activity is performed) is segregated into those costs that are to be depreciated over the expected useful life of the airframes and engines and those that represent the estimated cost of the next planned major maintenance activity. Thus, the estimated cost of the first planned major maintenance activity is separated from the cost of the remainder of the airframes and engines and amortized to the date of the initial planned major maintenance activity. The cost of that first planned major maintenance activity is then capitalized and amortized to the next occurrence of the planned major maintenance activity, at which time the process is repeated.

4.117 FinREC believes the expense as incurred method is preferable to all other methods of accounting for maintenance activities.

4.118 For parts sent to third-party FAA-approved maintenance repair stations for overhaul, repair, or both, under the expense as incurred method, the estimated cost of maintenance would need to be accrued over the period of repair. In certain cases, however, airlines may not be able to account for those costs over the period of repair due to lack of necessary information on a timely basis or other practical considerations. As a result, airlines have developed simplified conventions that reasonably approximate the costs incurred over the repair period, which include accounting for the cost of the maintenance (*a*) when parts are shipped to the third-party vendor, (*b*) upon receipt of shop estimates from the third-party vendor, or (*c*) when the maintenance work is completed. All of these options with third-party maintenance repair stations are considered acceptable as long as the airline chooses one approach and applies it consistently and as long as the results do not materially differ from the results obtained by accruing the costs over the period of repair.

Outsourcing Maintenance

4.119 Historically, most major airlines performed maintenance on their own aircraft in-house. They traditionally had sufficient fleet sizes to keep the maintenance and repair operations scheduled to full capacity for the entire year. With the advent of low-cost carriers and regional airlines (which fly only feeder traffic for their major network airline partners), many airlines began to use independent maintenance providers to provide more flexibility and reduce costs. The process lends itself to outsourcing because the maintenance activities are routine in nature and occur under established programs that are preapproved by the FAA for carriers operating in the United States. A number of airlines (including some major airlines) outsource some or all of the scheduled maintenance activities that must be performed on the engines and airframes they operate.

4.120 Generally, two types of contracts are used to provide these services: (*a*) time-and-material and (*b*) power-by-the-hour (PBTH) contracts. Traditional time-and-material contracts may fix certain components of the cost, but much of the contract price is based on actual cost at the time the maintenance event takes place. To accommodate the airline's desire to fix their costs, and partially as a tool used by the airframe and engine equipment manufacturers to sell their ongoing maintenance services, PBTH contracts were developed. Under PBTH contracts, airlines generally pay the service provider a fixed amount per flight hour in exchange for required maintenance and repairs under the predefined maintenance program. These contracts generally provide that, in exchange for a payment of a fixed amount per flight hour or other applicable unit of measurement associated with the aircraft (for example, block hour or cycle), the maintenance provider will provide specified maintenance activities associated with a particular aircraft for a specified period. PBTH contracts have many unique attributes but may include any of the following: (*a*) providing for a level fixed rate per flight hour without a provision for the flight hours accumulated at the contract commencement date, (*b*) containing a buy-in provision based on the flight hours accumulated to the point of entering into the PBTH contract, or (*c*) providing for an initial rate per flight hour that is lower than the rate per flight hour under the contract in the later period (usually related to new aircraft types).

4.121 PBTH contracts fix certain of the airline's costs and, therefore, transfer certain risks (including cost risk) associated with the maintenance activities to the service provider. One exception to the transfer-of-risk concept is that, under most of these contracts, the airline would continue to be responsible for foreign-object damages (FOD) or other items that were not within the scope of scheduled maintenance activities established initially. However, much like insurance contracts, an airline can include a predefined number of FOD events to be covered by the PBTH contract, generally based on the history of such events at the airline. In these cases, the FOD events that exceed a specified amount or tolerance are not covered by the contract and generally would be settled on a time-and-materials basis. Another exception is prospective rate adjustments for changes in the required maintenance program by the FAA or other rule makers or regulatory changes, such as in the number of flight hours until the replacement of certain life-limited parts is required. If these events occur, the contract calls either for renegotiation of the rate per flight hour or for renegotiation of specified components of the rate per flight hour.

4.122 Some major airlines provide maintenance to regional airlines under PBTH arrangements. In addition, as discussed in the "Maintenance Deposits" section of this chapter, some lease agreements require deposits or supplemental rent be paid to the lessor to fund future maintenance of the leased aircraft or engine. It is expected that these arrangements will also be accounted for based on the criteria discussed in the following paragraphs.

4.123 FinREC believes the issues relating to PBTH contracts and other similar arrangements with independent maintenance and repair providers include determining whether risk has been transferred to the service provider. The risk transfer criteria discussed in this section provide a framework for determining whether there is a transfer of risk. If the contract transfers risk, FinREC believes the airline should recognize maintenance expense in accordance with the PBTH contract, as opposed to following its maintenance accounting policy. In these situations, FinREC believes there is a presumption that the expense should be recognized at a level rate per hour during the minimum, noncancelable term of the PBTH agreement. That presumption could be overcome by evidence that the level of service effort varies over time, consistent with the variations in the payment pattern under the PBTH contract. Expense recognition is discussed in detail in this section.

4.124 If a contract does not meet the risk transfer criteria, FinREC believes the payments made under the contract should be recorded as a deposit or prepaid expense to the extent recoverable through future maintenance activities. When the underlying maintenance event occurs, it would be accounted for as maintenance expense or capitalized in accordance with the airline's maintenance accounting policy. Any nonrefundable amounts that are not probable of being used to fund future maintenance activities would be recognized as expense. If the cost per event is not specifically determined from the contract, the airline would record maintenance expense based on the best estimate of the cost of the underlying maintenance services. The amount of maintenance expense recorded would need to be supported by evidential matter. Such support could include prior costs for similar maintenance activities, documentation from a maintenance provider or other third parties, or both. Nonroutine maintenance, including payments under contracts for FOD or other out of scope work, would also be expensed as it is incurred.

Risk Transfer Criteria

4.125 The determination of whether risks and rewards have been transferred to the service provider may depend on, among other things, the contract, the related rights and obligations of each party in the event of termination, and whether contract payments are refundable. This assessment would be made at inception of the contract or after the contract has been substantially modified. Because each PBTH contract has different terms and objectives, it is difficult to provide specific conditions for all contracts. However, FinREC believes the following principles should be considered in determining whether there is a transfer of risk (exhibit 4-1 to this chapter provides a summary of contract provisions for five PBTH contracts and their effect on the determination of whether there is a transfer of risk):

- *True-ups.* For a transfer of risk to occur, the service provider must absorb and receive substantially all variability of the cost of maintenance required under the service contract. FinREC believes that a contract with payment terms calling for payments that are intended to approximate substantially all of the actual costs, but that requires a true-up to actual costs incurred by the maintenance service provider (either at various points in the contract or upon termination), does not meet the risk transfer objective. In addition, rate reset provisions that call for prospective PBTH rate adjustments that effectively serve to recover or pay back based on historical contract performance would not achieve this risk transfer objective.
- *Contract adjustment provisions.* The contract may provide for an adjustment payable by either party for out-of-scope work, including FOD and adjustments to the hours prior to the replacement of life-limited parts and still transfer risk. However, a contract that simply includes cost true-up provisions based on the service provider's cost experiences does not transfer risk. Contracts may

contain annual or periodic escalation provisions, either tied to specified inflationary or labor indices or specifically agreed to by the parties (including increases tied to certain performance criteria as long as they are capped or otherwise limited in allowing either party to mitigate the criteria in the previous bullet point) and still transfer risk, as long as they do not conflict with the other principles set forth in this section.

- *Termination provisions.* The contract may contain preestablished exit provisions for either party for cause or for other performance-related factors and still transfer risk as long as the contract does not result in the recovery of amounts paid or in the incurrence of any additional liability by the airline upon termination based on the relationship of contract payments to actual cost experience by the service provider or based on the relationship of payments made on a specific airframe or engine to work performed on that airframe or engine (cost true-up). Buy-out provisions that provide for recovery upon termination of the agreement of amounts paid related to the period since the last overhaul was performed would indicate a lack of risk transfer. However, a contract may reasonably provide for the successful satisfaction of each party's obligations under the contract that had been incurred prior to the termination and penalty provisions, if appropriate, and still transfer risk. Also, FinREC believes in order not to preclude risk transfer, termination provisions need to be substantive enough as to not effectively provide a planned exit opportunity for either party at their discretion.

An airline could also refer to the risk transfer criteria described in FASB ASC 944-20 for additional guidance.

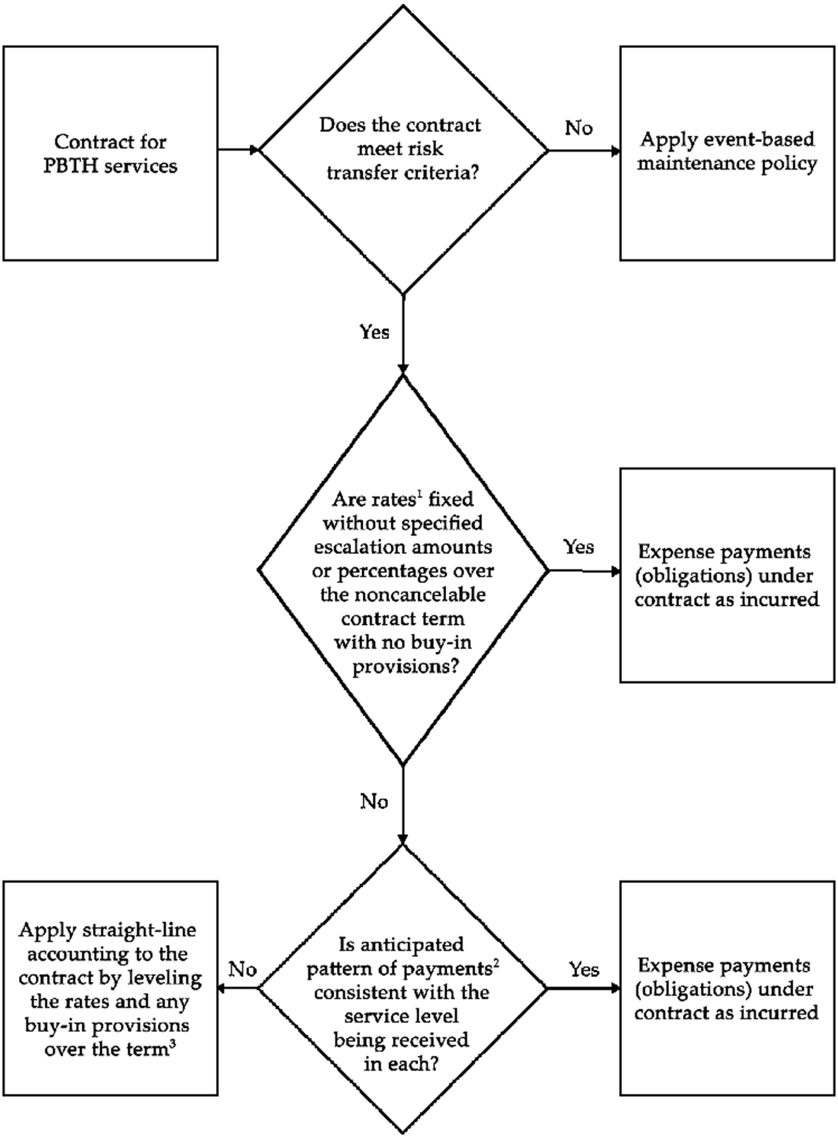
Expense Recognition

4.126 As previously mentioned, if risk has been transferred, FinREC believes there should be a presumption that the expense should be recognized at a level rate per hour. However, changes in contractual rates that are adjusted based on an index, such as the Consumer Price Index (CPI), or that cannot be reliably determined at the outset of the contract would not be leveled. In situations where rates are adjusted for CPI but the adjustment cannot be less than a certain minimum (for example, 1.5 percent), expense would be recognized at a level rate per hour based on the minimum increase. For PBTH contracts with other than straight-line rates per hour, the presumption that expense should be recognized at a level rate per hour can be overcome by evidence that the level of service effort provided under the contract varies over time and that the changes in the contractual rate per hour are consistent with the changes in the level of service effort to be provided under the PBTH contract. Examples of such evidence include (*a*) detailed service level estimates prepared by the service provider that indicate the planned service level in each of the periods and (*b*) projections of major maintenance events that will be covered under the contract, which indicate significant changes in service levels. If such evidence exists, expense would be recognized based on the rates in the PBTH contract.

4.127 PBTH contracts frequently contain buy-in provisions, especially in situations in which the fleet has been operated for some period of time prior to entering into the PBTH contract. For example, with a new fleet of aircraft, the airline will have very little planned major maintenance activities in the first few years of operating the aircraft, the so-called "maintenance holiday." As a result, an airline may enter into the PBTH contract after operating a fleet of aircraft for some time. In these situations, the service provider may require the airline to pay a buy-in provision for the hours flown on the aircraft prior to when the aircraft were placed in the PBTH program. FinREC believes that buy-in provisions represent just one variation of payment terms and that the timing of payments (for example, buy-in provision requiring cash payment at the time the airline enters the contract versus higher rates over the contract period to compensate the service provider for hours that accumulated before the contract was entered into) should have no effect on the determination of whether risk has been transferred or the total expense recognized over the term of the PBTH agreement. FinREC believes that risk transfer, and not the timing of payments, should determine the accounting. Therefore, if risk has been transferred, FinREC believes that the payments made for buy-in provisions should be recognized over the minimum noncancelable contract term consistent with the presumption that the expense should be recognized at a level rate per hour as discussed previously.

4.128 Some believe that the buy-in payments relate to time incurred prior to the aircraft entry into the contract and should, therefore, be expensed when paid under the contract. However, FinREC believes that despite the fact that the contract may obligate the airline to make the payment, immediate recognition of that payment as expense (presumably for prior service) would be inconsistent with accounting treatment for the other PBTH provisions (recognizing expense at a level rate), or the application of the payments consistent with the service level being received, as described previously.

4.129 The following flowchart provides a model for the evaluation of PBTH contract payment terms to consider the possible effect of straight-lining.



1 Denotes the rate to be applied to the applicable usage measure in the contract (for example, flights, hours, or cycles).

2 Implies rate specifics in the contract times estimated usage in each period.

3 See exhibits 4-3A–4-3C for examples of the application of straight-line accounting to PBTH contracts.

4.130 This model applies the basic concept that expense is to be recognized in accordance with the service level being received by the airline. Exhibit 4-2 in this chapter provides examples of how the model would be applied in various scenarios. If rates are not constant and an airline cannot conclude that the contractual payment terms reasonably match the service level expected to be received during the noncancelable term of the contract, then expense would be recognized on a straight-line basis over the noncancelable contract term. If there is a change in the variables used in the calculation of the periodic expense (that is, total number of hours expected to be flown over the contract period or the distribution of those hours among periods), such changes in estimates should be accounted for on a prospective basis in accordance with FASB ASC 250-10-45-17. An example of the PBTH rate calculation and leveling is included in exhibits 4-3A–4-3C in this chapter.

Spare Parts

4.131 Spare parts are typically grouped into several broad categories: rotables, repairables, expendables, and materials and supplies. The following table provides brief descriptions of the categories and accounting treatment for each category.

Spare Parts Category	*Accounting Treatment*
Rotable parts typically are significant in value and can be repaired and reused such that they typically have an expected useful life approximately equal to the aircraft they support.	Rotable parts are capitalized and classified along with flight equipment as fixed assets. Rotable parts are normally depreciated over their useful lives or the remaining service lives of the related equipment. The cost of repairing rotables is charged to expense as it is incurred.
Repairable parts are repairable and reusable but with economic useful lives generally less than the aircraft they support and values less than most rotable parts.	The Accounting Standards Executive Committee believes that repairable parts, along with certain life-limited rotable parts, can be classified as either expendables in current assets or as rotables in fixed assets. Repairable parts are normally depreciated over the lesser of their useful lives or the remaining service lives of the related equipment. The cost of repairing repairable parts is charged to expense as it is incurred.
Expendable parts cannot be economically repaired, reconditioned, or reused after removal from the aircraft.	Expendable parts are recorded as a current asset and are charged to expense as they are used or consumed in operations (that is, placed on an aircraft). Expendable parts are valued at cost, less an allowance for obsolescence.
Miscellaneous materials and supplies support flight or ground equipment.	Miscellaneous materials and supplies are either classified with expendable parts in current assets or are expensed upon purchase. Classification of specific parts ordinarily depends on the carrier's maintenance program.

4.132 Because rotable parts are classified and considered fixed assets, the asset valuation of rotable parts is similar to that of other property and equipment. As replacement parts for rotable parts are purchased, they are capitalized. Rotable parts are normally depreciated over their useful lives or the remaining service lives of the related equipment. Airlines have traditionally depreciated these rotable parts on a pooled basis over the estimated service lives of the related aircraft. See the "Depreciation" section in this chapter for further details.

4.133 Rotable parts are generally acquired along with the aircraft, and the number of parts is dependent on the number of aircraft in the fleet, locations served, and other factors. They are called rotable parts because they rotate between the spare parts pool and the aircraft or engine. Examples of rotable parts include aircraft avionics, engine blades, and landing gears. Because rotable parts can be repaired and reused, they are serialized for tracking purposes. Due to FAA requirements, an airline is required to maintain records of the location of and the maintenance performed on each serialized rotable part. Airlines typically record this information within their maintenance systems.

4.134 Operationally, when a rotable part is installed on an aircraft, the old part is taken off and replaced with a similar part from the pool of rotable parts. The removed unserviceable rotable part is repaired and then placed back in the spare parts pool for use on another aircraft after being made serviceable. The cost to repair the part is expensed as incurred. The aircraft and the related rotable parts continue to be depreciated over their estimated useful life. Until a rotable part is scrapped, it retains its functionality and just moves among various locations and aircrafts. When a rotable part is removed from service and scrapped, the cost of the scrapped rotable part is charged to accumulated depreciation, consistent with established depreciation policies.

4.135 Rotable, repairable, and expendable spare parts recovered in connection with construction or maintenance are recorded at net realizable value. This valuation is typically based on the condition of the part or group of parts and the part's continuing utility. The average cost of comparable items is usually used as an estimate for net realizable value by the airlines. These parts are then depreciated (if they are classified as either rotable or repairable parts), or charged to expense when used (if they are classified as expendable parts). Usable parts that are stripped from retired aircraft are recorded at their fair value, with the aggregate value of the parts not to exceed the carrying amount of the aircraft from which these parts were removed. See paragraph 4.52 for more information on how to value such parts.

Allowance for Obsolescence

4.136 An airline establishes an allowance for obsolescence[4] to distribute the cost of expendable parts expected to be on hand at the end of a fleet's life over the service lives of the related equipment. In making this calculation, the airline can classify parts by type of aircraft. The airline also takes into account the estimated useful life of each type of aircraft fleet, the level of expendable

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[4] Please note that the term *allowance for obsolescence* is generally used in connection with inventory accounts. However, as used in this guide, this industry-specific term has a different meaning and is related to expendable spare parts.

parts expected to be on hand at the end of the useful life, and the estimated salvage value of the parts.

4.137 Because expendable parts supplies typically turn over numerous times during the useful life of an aircraft fleet, an airline can also manage, to some extent, the level of spare parts expected to be on hand at the end of the useful life of the fleet (referred to as *base stock*). Airlines often phase out fleets over several years. As these aircraft come out of service over that period, the airline can reduce the amount of expendable parts on hand by purchasing fewer parts and, thus, phasing these parts out by reduced purchasing. As a result, some airlines may conclude that the level of expendable parts on hand at the end of the fleet life (the estimated base stock) will be less than the total net book value of expendable parts prior to the end of the fleet life. As a result, the obsolescence allowance computation may consider less than the entire expendable parts supply on hand at any point in time. For example, an airline may conclude that for a particular fleet, due to a long time period over which the fleet will be retired, only 40 percent of its current level of expendable parts will be on hand at fleet retirement and, as such, only 40 percent of expendable parts is subject to an obsolescence allowance. FinREC believes it is not reasonable for an airline to assume that it can dispose of its entire expendable parts supply prior to fleet retirement and not record an allowance.

4.138 Typically, the spare parts obsolescence provision for the period is calculated by taking the estimated base stock cost; reducing it by the estimated salvage value and the current allowance for obsolescence; and then dividing the remaining amount by the remaining useful or average service life of the aircraft to which they relate.

4.139 In addition to this allowance, a separate evaluation is periodically made of expendable parts that are considered excess to the airline's needs or surplus or obsolete due to engineering change orders, fleet changes, and so on. Once evaluated, additional obsolescence charges may be required for these excess or surplus or obsolete parts. A good management practice would be to review allowances periodically for reasonableness in relation to changes in technology and changes in the estimated useful or service lives of the aircraft.

Inherent Risk Factors

4.140 Factors that influence inherent risk related to acquiring and maintaining property and equipment might include the following:

- New aircraft acquisition contracts, which may include purchase incentives, cost guarantees, and other contractual obligations associated with aircraft acquisition contracts
- The complexity of financing utilized to purchase aircraft and whether the aircraft was financed under a lease or secured debt financing, including whether interest rates are at market and whether interest is variable or fixed
- Determining the classification of leases as capital or operating can be complex and subject to significant judgments and estimates
- Leasing structures involving trusts or other entities that have few or no operations other than leasing a specific asset or group of assets and the related evaluation of whether they are VIEs

- Continued losses that might indicate impairment exists on assets held for use
- Unstable economic environment of the airline industry and industry trends with regard to discontinuing manufacturing of certain fleet types or new fleet types that affect the values of existing fleets and the related spare parts
- Fleet plans of other airlines (passenger and nonpassenger) that affect the fair values of aircraft and the related spare parts
- Delays and other changes to aircraft acquisition contracts and their effect on recoverability of certain fixed assets, including related capitalized interest
- The complexity and frequency of fleet plan changes
- The level of modifications being made to aircraft fleets
- Subjective interpretation of management plans for the disposition of aircraft when evaluating whether the aircraft meets the held-for-sale criteria
- The airline's history associated with fleet retirements and accuracy of its estimates of obsolescence reserves
- Appropriateness of depreciable lives due to fleet plan modification or impairment assessment
- Whether aircraft maintenance is performed in-house or outsourced and the terms of outsourcing arrangements
- New agreements that provide for spare parts to be used by the airline
- The number of locations where parts are maintained

Exhibit 4-1

Power By The Hour Contract Attributes and Risk Transfer Evaluation

Contract Attributes	*Contract A*	*Contract B*	*Contract C*	*Contract D*	*Contract E*
Term	Long-term (>5 years)	10 years	10 years	10 years	6 years
Scope	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract	Routine engine maintenance. Any unusual rework outside scope of contract
Up-front payment	Yes	No	No	No	Yes
Timing of payment	Monthly with various adjustments described below	Monthly based upon flight hours	At time of engine event based upon number of hours since last maintenance event	At time of engine event based upon number of hours since last maintenance event	Monthly based upon flight hours
Basis for charge (that is, amount per flight hour)	\$X Year 1 \$Y Year 2 \$Z Year 3+ Per flight hour	\$X Year 1 \$Y Year 2 \$Z Year 3+ Per flight hour	Fixed rate per flight hour, adjusted for inflation based upon materials price index	Fixed rate per flight hour adjusted for CPI	Fixed rate per flight hour adjusted for CPI, not less than 1.5 percent

(continued)

Power By The Hour Contract Attributes and Risk Transfer Evaluation—*continued*

Contract Attributes	*Contract A*	*Contract B*	*Contract C*	*Contract D*	*Contract E*
Price escalation adjustment and how often	Yes—pursuant to formula in contract (Consumer Price Index [CPI] based) Calculated annually	Nonprogram work is at contractual labor rates that are subject to CPI—rate per hour does not change	Adjusted annually	Adjusted annually	Adjusted annually
Periodic true-up adjustments under the contract	Yes, annually—based on changes in utilization versus estimates (that is, flight hours) and actual costs versus estimates	Yes annually—based upon number of qualifying engine events	None	None	None
Termination provision	None	Upon default by either party (as defined) or bankruptcy	Upon default by either party (as defined) or bankruptcy	Upon default by either party (as defined) or bankruptcy	Upon default by either party (as defined) or bankruptcy
Settlement at termination	None	None	None	None	Settlement based on actual costs of the service provided versus payments received under the contract

Power By The Hour Contract Attributes and Risk Transfer Evaluation—*continued*

Contract Attributes	*Contract A*	*Contract B*	*Contract C*	*Contract D*	*Contract E*
Risk transfer conclusion (Yes or No)	No	No	Yes	Yes	Possibly. See the following explanation.
Basis for risk transfer conclusion	Annual true-ups to actual costs incurred by the service provider do not result in risk transfer to the service provider.	Annual true-ups based on the number of actual engine events experienced is considered sufficiently different from the criteria used to make payments under the contract (that is, flight hours) such that the contract does not effectively transfer risk.	This contract provides for no true-up provisions (either annually or upon termination), and pricing terms are fixed such that a full risk transfer has occurred.	This contract provides for no true-up provisions (either annually or upon termination), and pricing terms are fixed such that a full risk transfer has occurred.	This contract provides for a true-up upon a default by the service provider. In this situation, the default provisions would need to be evaluated to determine if those provisions are substantive (for example, not effectively providing a planned exit opportunity for either party at their discretion). If they are substantive, the Accounting Standards Executive Committee believes risk transfer has occurred.

Exhibit 4-2

Example of Power by the Hour (PBTH) Payment Term Model Applications

	Example A	*Example B*	*Example C*	*Example D*
Risk transfer	Yes	Yes	Yes	Yes
Term	6 years	6 years	6 years	6 years
Payments and related terms	\$95 per flight hour in years 1–3 \$120 per flight hour in years 4–6	\$110 per flight hour, adjusted annually based on the Consumer Price Index	\$100 per flight hour, adjusted annually based on 50% of the parts materials cost index	\$95 per flight hour in years 1–3 \$120 per flight hour in years 4–6
Fleet type	New	Mature	New	Mature
Expense recognition	Accrue expense as flight hours are incurred, based on rate in effect for the applicable contract period (that is, expense as incurred).	Accrue expense as flight hours are incurred, based on rate in effect for the applicable contract period (that is, expense as incurred).	Accrue expense as flight hours are incurred, based on rate in effect for the applicable contract period (that is, expense as incurred).	Recognize expense on a straight-line basis over the contract term.
Basis for conclusion	Although the contract does provide for fixed escalating rates per flight hour, the airline concluded that the anticipated annual payments are consistent with the level of service to be received on a new fleet that needs less maintenance in its first three years of service than in subsequent years. Therefore, expense is based on the periodic rates set forth in the PBTH contract.	The contractual rates are adjusted based on an index rather than a fixed amount or percentage.	The contractual rates are adjusted based on an index rather than a fixed amount or percentage.	The contract provides for fixed escalating rates per flight hour, and, because the related fleet is mature, the airline concluded that the annual payments are not necessarily consistent with the level of service to be received. Therefore, expense is recognized on a straight-line basis over the noncancelable contract term.

Exhibit 4-3A

Power By The Hour (PBTH) Rate Calculation and Leveling Considerations

Scenario A—Base case expected for a PBTH contract with a 4-year term.

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Total*
Flight hours anticipated	2,500	2,700	3,000	2,200	10,400
Rate per hour applicable	$93.00	$98.00	$101.00	$120.00	$102.32
Anticipated payments	$232,500	$264,600	$303,000	$264,000	$1,064,100
Leveled expense[(a)]	$255,793	$276,257	$306,952	$225,098	$1,064,100
Difference	($23,293)	($11,657)	($3,952)	$38,902	

[(a)] Determined based on the application of the anticipated overall contract rate (that is, total anticipated payments over the contract term divided by total anticipated flight hours—in this example: $102.32) to flight hours for the period.

Exhibit 4-3B

Power By The Hour (PBTH) Rate Calculation and Leveling Considerations

Scenario B—Base case expected for a PBTH contract with a 4-year term, adjusted based on the actual flight hours in year 1, but no change in total hours anticipated over the contract term.

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Total*
Flight hours anticipated	2,800	2,700	3,000	1,900	10,400
Rate per hour applicable	$93.00	$98.00	$101.00	$120.00	$101.54
Anticipated payments	$260,400	$264,600	$303,000	$228,000	$1,056,000
Leveled expense[(b)]	$286,488	$273,379	$303,755	$192,378	$1,056,000
Difference	($26,088)	($8,779)	($755)	$35,622	

[(b)] Computed the same as the rate in scenario A, except that the rate is adjusted after year 1, based on the actual flight hours incurred in year 1. In this calculation, year 1 is calculated at the overall contract rate computed in scenario A (that is, at the inception of the contract) multiplied by actual flight hours for year 1. Then the year 2–4 rate is recomputed by taking the total anticipated payments less year 1 expense, divided by the remaining anticipated flight hours in years 2–4.

Exhibit 4-3C

Power By The Hour (PBTH) Rate Calculation and Leveling Considerations

Scenario C—Base case expected for a PBTH contract with a four-year term, adjusted based on the actual hours in year 1 and a change in total hours anticipated over the contract term.

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Total*
Flight hours anticipated	2,800	2,700	3,000	2,500	11,000
Rate per hour applicable	$93.00	$98.00	$101.00	$120.00	$102.55
Anticipated payments	$260,400	$264,600	$303,000	$300,000	$1,128,000
Leveled expense[c]	$286,488	$277,083	$307,870	$256,558	$1,128,000
Difference	($26,088)	($12,483)	($4,870)	$43,442	—

[c] Computed the same as the rate in scenario A, except that the rate is adjusted after year 1, based on the actual flight hours incurred in year 1 and the revised anticipated total flight hours over the contract term. In this calculation, year 1 is calculated at the overall contract rate computed in scenario A (that is, at the inception of the contract) multiplied by actual flight hours for year 1. Then the year 2–4 rate is recomputed by taking the revised total anticipated payments less year 1 expense, divided by the revised remaining anticipated flight hours in years 2–4.

Chapter 5

Employee-Related Costs

General

5.01 Salaries, wages, and benefits are among airlines' most significant operating expenses. Almost all major airlines provide their employees with a variety of benefits, including defined benefit and defined contribution pension plans, other postretirement benefits (such as certain health care and life insurance benefits), and postemployment benefits. Certain of these benefits are discussed in detail in this chapter. Typically, low-cost airlines do not offer defined benefit plans or other postretirement benefits. The majority of airline employees belong to unions, and an airline frequently has a number of unions representing its various work groups.

Amendable Labor Contracts

Background

5.02 Labor contracts in the airline industry are covered under collective bargaining agreements (CBAs) that are governed by the Railway Labor Act of 1926. Under the provisions of the Railway Labor Act, CBAs do not expire, but rather become amendable as of a stated date. Contract employees may not strike upon a contract becoming amendable but must continue to work under the terms of the existing CBA until certain actions have taken place. If either party wishes to modify the terms of the existing CBA, it must notify the other party in the manner described in the agreement. After receipt of such notice, the parties must meet for direct negotiations and, if no agreement is reached, either party may request the National Mediation Board (NMB) to appoint a federal mediator to participate in the negotiations for a new or amended CBA. If no agreement is reached in mediation, the NMB may determine, at any time, that an impasse exists and offer binding arbitration to the parties. Either party may decline to submit to arbitration. If arbitration is rejected by either party, a 30-day cooling off period begins. At the end of this 30-day period, the parties may engage in *self-help*, unless the President of the United States appoints a Presidential Emergency Board (PEB) to investigate and report on the dispute. Self-help includes, among other things, a strike by the union, the imposition of proposed changes to the CBA by the airline, the hiring of new employees to replace any striking workers, or the outsourcing of job functions. However, if there is a strike, the President can order employees to return to work. The appointment of a PEB maintains the status quo for an additional 60 days. If the parties do not reach an agreement during this period and no action is taken by the U.S. Congress (which can enact legislation that imposes a settlement on the parties), the parties may again engage in self-help.

5.03 In times of relative economic stability, CBAs generally include increases in wages and other benefit enhancements; in periods of economic downturn and increased competition, wage and benefit reductions and changes to work rules resulting in increased productivity have been more common.

5.04 Neither party is required to agree to modifications prior to the amendable date of a CBA unless stipulated in the agreement, although nothing

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prevents the parties from agreeing to start negotiations or to modify the CBA in advance of the amendable date. The contract negotiation process can be quite lengthy, and at times, employees covered by a CBA have worked for a period of years beyond the amendable date under the existing CBA while the new CBA was being negotiated. Because of the significant delay, the new CBA may include provisions calling for retroactive wage payments to compensate employees for the period between the amendable date and the ratification date of the new contract. Many forms and types of pay and benefits can be provided to compensate the employees for working during the amendable period. Retroactive pay is characterized by the fact that it is paid to employees for services provided during the amendable period. Employees who terminate employment prior to the finalization of a new contract may still be eligible for retroactive pay.

Accounting Guidance

5.05 The guidance that follows applies to retroactive wage payments only. This section does not address other compensation and benefits, such as pensions, that should be accounted for in accordance with other applicable literature. The form of payment (for example, cash or share-based) may affect the accounting for retroactive pay discussed in this section.

5.06 The AICPA Financial Reporting Executive Committee (FinREC) believes that airlines should follow the guidance in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*, in determining when to recognize a liability for retroactive wage payments. FASB ASC 450-20-25-2 requires the accrual of a liability if (*a*) information available prior to issuance of the financial statements or when they are available to be issued indicates that it is probable that a liability had been incurred at the date of the financial statements and (*b*) the amount of loss can be reasonably estimated.

5.07 The underlying events causing the airline to consider recognizing a liability are (*a*) the CBA becoming amendable and (*b*) the continuation of employee service during the amendable period. FinREC believes that for a liability to be recognized in the financial statements, these events must have occurred before the date of the financial statements.

5.08 In many cases, application of the model outlined in the following sections would result in the accrual of a liability at a point prior to contract ratification.

Probability That a Liability Has Been Incurred

5.09 The following are some of the factors that are integral to assessing whether it is probable that a liability for retroactive wages has been incurred:

- Prior history of the airline and the labor group with which it is negotiating (whether the airline has a demonstrated history of making or not making retroactive wage payments).
- Management's intent to provide retroactive wages (whether management has obtained the board of directors' approval to offer retroactive wages as part of the package).
- The existence of an offer of retroactive wages (whether an offer has been made that includes a provision for retroactive wages).

- Union group's expectations (whether the union group expects retroactive wages to be a part of the final contract. This may be difficult to determine and, therefore, will be based on management's reasonable belief and other evidence available to the airline, such as management's current interaction with the union group during the contract negotiation process.).
- The terms of recent agreements reached by other airlines with similar union groups (recent completed agreements are frequently used as benchmarks for other agreements being negotiated).

Ability to Reasonably Estimate the Liability

5.10 Because the CBA negotiation process is fluid, with numerous proposals and counterproposals, it may be difficult to make reasonable estimates in the early stages of the negotiation process. Estimates developed in the early stages of the negotiation process in many cases later require significant revision. Further complicating the estimation process is the fact that airlines have multiple means of compensating employees, which could alleviate the need for retroactive wages. For example, an enhanced pension benefit might be provided in lieu of retroactive wages.

5.11 For airlines, the range of an estimated retroactive wage liability will be defined and refined as events in the negotiation process occur, as related to the guidance of FASB ASC 450-20-25-5, which concludes that the criterion for recognition of a loss contingency in FASB ASC 450-20-25-2—that "the amount of loss can be reasonably estimated"—is met if a range of loss can be reasonably estimated.

5.12 Any change in the airline's estimate of retroactive wage liability needs to be based on reliable information, and the effect of the change should be accounted for by adjusting the accrual in the period of change if the change affects that period only or in the period of change and future periods if the change affects both in accordance with FASB ASC 250-10-45-17.

5.13 FASB ASC 250-10-50-4 states that disclosure is required if the effect of a change in the estimate is material to the interim or annual financial statements.

5.14 Following are two examples of the accounting for changes in estimates related to amendable labor contracts. These examples assume that Airline A has a history of paying retroactive wages, and that management intends to offer retroactive wages as a component of the new CBA. Additionally, new CBAs at other airlines have continued the trend of increasing base wage rates, thus causing pilot wage rates at Airline A to fall below market. Based on these factors, management believes it is probable that retroactive wages will be paid and can be reasonably estimated.

Increase in Estimate

5.15 Airline A is negotiating a new CBA with its pilots. The existing CBA has an amendable date of June 30, 20X4. In the 12 months subsequent to June 30, 20X4 (the amendable date), pilot wages (based on the terms of the existing CBA) were $500,000,000. Airline A estimates an increase to pilot wages of 2.5 percent and believes it will take 2 years to negotiate and ratify a new CBA. Accordingly, Airline A accrued $12,500,000 for retroactive wages for the year ended June 30, 20X5. In July 20X5, Airline A concludes, based on a recent agreement reached by another airline and its pilots, that its best estimate of an increase in retroactive wages is 4.5 percent. As a result of the change in its estimated retroactive pay, Airline A increases its accrual for pilot retroactive wages by $10,000,000 for the 12-month period ended June 30, 20X5 (to a total of $22,500,000) in July 20X5, with a corresponding charge to salaries and benefits expense to reflect this change in estimate. If the financial statements for the quarter ended June 30 were not issued or available to be issued by the time of the decision, this change would be accounted for in the June quarter as a recognized subsequent event in accordance with FASB ASC 855, *Subsequent Events*. Airline A will also prospectively accrue $5,625,000 for the quarter ended September 30, 20X5 ($22,500,000 divided by 4).

Decrease in Estimate

5.16 Airline A is negotiating a new CBA with its pilots. The existing CBA has an amendable date of June 30, 20X4. In the 12 months subsequent to June 30, 20X4 (the amendable date), pilot wages (based on the terms of the existing CBA) were $500,000,000. Airline A estimates an increase to pilots wages of 2.5 percent and believes it will take 2 years to negotiate and ratify a new CBA. Accordingly, Airline A accrued $12,500,000 for retroactive wages for the year ended June 30, 20X5. In July 20X5, Airline A management decides, based on a new offer from its pilots, to eliminate the proposed retroactive wage increase of 2.5 percent in return for bonuses in future years if Airline A meets certain financial thresholds in those years. As a result of the elimination of the expected retroactive pay raise, in July 20X5, Airline A reverses its $12,500,000 accrual for pilot retroactive wages for the 12-month period ended June 30, 20X5 (with a corresponding credit to salaries and benefits expense to reflect this change in estimate), and discontinues further accrual of retroactive wage payments. If the financial statements for the quarter ended June 30 were not issued or available to be issued by the time of the decision, this change would be accounted for in the June quarter as a recognized subsequent event in accordance with FASB ASC 855.

Evaluation Points

5.17 Due to the fluid nature of negotiations between airlines and their various work groups, it is difficult to assess the probability of retroactive wages or to estimate a range of amounts of those wages. It would not be unusual for two airlines to reach different conclusions based on similar facts. However, in an effort to promote consistency, FinREC has set out the events in the CBA negotiation process that are listed subsequently. FinREC believes these events mark the points in the negotiation process at which the probability that a liability has been incurred and the extent to which any liability is reasonably estimable should be evaluated. The list of these events is arranged in ascending order; that is, the likelihood of accruing a liability increases toward the end of the list and is also higher when more than one of these conditions exist with respect to an airline. It is assumed that, at each of these points, the contract is amendable, and the airline has a history of paying retroactive wages. This guidance would need to be applied based on the facts and circumstances of the particular contract negotiation. These evaluation points are as follows:

- Recently negotiated union contracts at other airlines during the amendable period of the contract in question with significant increases in wage rates may lead to requests for retroactive wages during the amendable period.

- Management begins negotiations with an expectation that retroactive wages will be a component of the future CBA.
- Substantive communication from management indicates that retroactive wage payments will be a part of the new CBA.
- Management has made an offer that includes retroactive wages.
- A tentative settlement is reached with union leadership, subject to union ratification, which includes retroactive wages.
- The board of directors approves the new CBA containing retroactive wages or, alternatively, a bankruptcy court approves the new CBA.

5.18 Once a CBA is ratified, the retroactive wage liability would be adjusted to reflect the estimated amount payable under the new CBA.

5.19 If an airline has no history of providing retroactive wages during periods when contracts are amendable, an accrual would be inappropriate absent strong evidence to the contrary (that retroactive wages will be part of the final contract).

Disclosures

5.20 See the "Risks and Uncertainties" section of chapter 7, "Financial Reporting and Disclosures," for disclosure considerations related to amendable labor contracts.

Pensions

Background

5.21 Pensions are a major cost for many airlines and involve the application of complex accounting guidance. Most traditional airlines have a wide array of pension arrangements and typically provide benefits using a combination of defined benefit and defined contribution plans. Low-cost airlines generally provide benefits under defined contribution plans. Through years of labor negotiations, some airlines have provided pension benefit enhancements in lieu of current cash consideration. In addition, because of competition and the growth of low-cost airlines, many traditional airlines have terminated, frozen, or otherwise modified their defined benefit plans to reduce costs and conserve cash.

5.22 During periods of high interest rates, high asset valuations, and high market returns, the traditional airlines' pattern of enhancing retirement benefits kept cash compensation low and did not have a negative effect on the plans' funded status. However, in periods of low interest rates and below-average asset returns, substantial increases in pension obligations, underfunded pension plans, and increasing annual pension costs occurred, requiring an increased level of cash funding. These conditions have historically resulted in significant underfunding of the airline industry's defined benefit plans.

5.23 FASB ASC 715, *Compensation—Retirement Benefits*, provides guidance on accounting issues and required disclosures for pensions.

Critical Assumptions

5.24 Critical assumptions used in the measurement of net periodic pension cost and the projected benefit obligation and determination of funded status are the discount rate, expected long-term rate of return, rate of compensation increase, expected rate of retirement, expected rate of turnover, recall rates of furloughed employees, and the mortality curve. FASB ASC 715-30-35-42 requires an explicit approach to assumptions; that is, each significant assumption used should reflect the best estimate solely with respect to that individual assumption. Actuarial assumptions reflect the time value of money, the discount rate, and the probability of payment (assumptions as to mortality, turnover, early retirement, and so forth). Some of these assumptions are discussed in the following sections.

Discount Rate

5.25 In accordance with FASB ASC 715-30-35-43, assumed discount rates should reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation (including information about available annuity rates published by the Pension Benefit Guaranty Corporation [PBGC]). In making those estimates, an employer may also look to rates of return on high quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. Assumed discount rates are used in measurements of the projected, accumulated, and vested benefit obligations and the service and interest cost components of the net periodic pension cost.

5.26 As discussed in FASB ASC 715-30-35-44, the objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. Notionally, that single amount, the projected benefit obligation, would equal the current market value of a portfolio of high quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. However, in other than a zero coupon portfolio (such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments), the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates should be extrapolated from the existing yield curve at the measurement date.

5.27 In Emerging Issues Task Force Topic No. D-36, "Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions," the Securities and Exchange Commission staff indicated that they believe fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency may be considered high quality. Under this approach, the airline selects a benchmark index rate, such as Moody's Aa corporate bond index as the starting point for calculating its discount rate. When using this approach, an airline would determine whether the timing and amount of cash outflows of the bonds in the index generally matches the timing and amount of the estimated benefit payments and would adjust the index rate for any significant differences. Although benchmarking the rate against the rate used by industry peers can help an airline in assessing the reasonableness of its discount rate, benchmarking is not the basis for selecting the discount rate (or any other assumption) because it does not take into account the variations in plan or participant characteristics. It is recommended that documentation and support for the discount rate are not be limited to actuarial valuations or peer entity comparisons but rather are based on the entity's specific facts and circumstances.

Expected Long-Term Rate of Return

5.28 The expected long-term rate of return is an assumption as to the rate of return on plan assets reflecting the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. It needs to be consistent with the current asset mix in the portfolio. The expected long-term rate of return is estimated based on many factors including, among other things, (*a*) the expected asset allocation, (*b*) assumed market volatility of the portfolio, (*c*) the plan's investment policy, (*d*) the method of constructing a best estimate range of investment returns, (*e*) historical returns by asset category, and (*f*) analysts' forecasts of market returns.

Airline-Specific Assumption Considerations

Rate of Compensation Changes, Expected Rates of Retirement, and Turnover

5.29 Although the effects on current year expense and the projected benefit obligation of a change in the expected rate of retirement, turnover rate, and rate of compensation increase are not as dramatic as those of a change in the discount rate and expected long-term rate of return, the airline and its auditors would need to ascertain that the expected rate of retirement, turnover rate, and rate of compensation increase are consistent with the airline's actual experience, plan design or CBA agreements, and future expectations in the industry.

5.30 During periods of economic uncertainty in an industry characterized by wage concessions and revised CBAs that keep future salary increases to a bare minimum, some airlines reduce the weighted-average rate of compensation increase to the current CBA rate of increase as the ultimate rate. However, if the current CBA provides for no salary increases, it is not appropriate to use zero as the ultimate rate of compensation increase. It is acceptable to assume that there will be no compensation increases for a certain number of years, but eventually the rate will have to increase in response to inflationary pressures.

Furlough Return Rate

5.31 Furloughs and layoffs are common in the airline industry during downturns in the economy. The furlough rate of return can be a significant factor in determining the appropriate accounting estimates to be used for pension accounting. Furloughs generally affect pension estimates because certain furloughed employees can continue to participate in defined benefit plans as long as they stand ready to return to work. An airline needs to accurately estimate not only the number of employees who will be recalled but also the effect of the recall on future service and other significant pension estimates.

Termination of Pension Plans

Accounting Guidance

5.32 An airline may terminate or make significant changes to its existing defined benefit plan. Airlines should evaluate terminations or other significant modifications to pension plans under the provisions of paragraphs 74–96 of FASB ASC 715-30-35 to determine if a curtailment, settlement, or both has occurred.

5.33 During periods of restructuring, there may be events in which a settlement, as defined in the FASB ASC glossary and discussed in paragraphs 74–91 of FASB ASC 715-30-35, has occurred. These events are associated with plan terminations or lump sum payouts driven by actions of the plan sponsor.

5.34 FASB ASC 715 also provides guidance on accounting for small recurring settlements that may occur when lump sum payments are made to retirees. Such settlements may occur in periods of financial uncertainty at the airline when employees are taking early retirement or early retirement packages are being offered, which causes the amount of lump sum payouts to increase, as compared with other years. Per FASB ASC 715-30-35-82, recognition in earnings of gains or losses from settlements is required if the cost of all settlements during a year is greater than the sum of the service cost and interest cost components of net periodic pension cost for the pension plan for the year.

Pension Benefit Guaranty Corporation

5.35 The PBGC, a federal government agency established under Title IV of the Employee Retirement Security Act of 1974, administers the federal pension plan insurance program for defined benefit plans. The PBGC will be a major creditor of an airline in a bankruptcy proceeding if the airline sponsors an underfunded defined benefit plan. The PBGC may take over a defined benefit plan in the following situations: (*a*) standard termination, (*b*) distressed termination (bankruptcy situation or severe funding issues), and (*c*) involuntary termination (termination at the direction of the PBGC). With respect to pension plans turned over to the PBGC, settlement accounting is generally appropriate if the plan assets and obligation are transferred to the PBGC and if the plan takeover is irrevocable.

Other Postretirement Benefits

5.36 Certain airlines, especially traditional ones, offer other postretirement benefits, which generally consist of retiree medical benefits, bridge medical benefits (that provide coverage for retirees from the point of retirement to the age of 65 when they become eligible for Medicare), life insurance, and other benefits. Employees may make contributions toward funding a portion of these other postretirement benefits. Because other postretirement benefits represent a significant cost for airlines due to rising health care costs, they are often the subject of negotiation during contract discussions.

5.37 FASB ASC 715-60 provides guidance on accounting for other postretirement benefits. To the extent that the promise to provide postretirement benefits is similar to the promise to provide pension benefits, the accounting for such promises is similar to the accounting set forth in FASB ASC 715-30, which governs pension accounting. Accordingly, issues encountered when accounting for other postretirement benefits are similar to pension accounting issues. For example, when there is a change that decreases the benefits offered under other postretirement benefit plans, the airline needs to determine whether a negative plan amendment, curtailment, or settlement has occurred and the appropriate accounting for each event. Airlines need to distinguish between a negative plan amendment (which reduces benefits) and a curtailment (which eliminates the expected years of future service by active plan participants). Alternatively, when there is a change that increases other postretirement benefits, and the change grants credit for prior service, the cost of the benefit improvement should be recognized as a charge to other comprehensive income at the date of the amendment. It is treated as prior service cost and amortized as a component of net periodic postretirement benefit cost over the remaining service period of the currently active employees who will receive the benefit. However, other postretirement benefits do not have the same funding requirements mandated by law as pensions.

5.38 Critical assumptions used in the determination of net periodic postretirement benefit cost, the accumulated postretirement benefit obligation, and funded status are the discount rate, expected long-term rate of return, and the health care cost trend rate. The discount rate and expected long-term rate of return on assets are determined in a manner that is consistent with the methodology described in the "Pensions" section of this chapter. The health care cost trend rate is an assumption about the annual rate(s) of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the composition of the plan population by age and dependency status, for each year from the measurement date until the end of the period in which benefits are expected to be paid. The health care cost trend rate implicitly considers estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants. Differing kinds of services, such as hospital care and dental care, may have different trend rates. The health care cost trend rate is generally determined by the airline with assistance from an actuary.

Other Key Employee Benefits

5.39 Other key benefits include, but are not limited to, workers' compensation (WC), salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including WC), job training and counseling, and continuation of benefits such as health care benefits and life insurance coverage. Benefits may be paid as a result of a disability, furlough or layoff, leave of absence, death, or other events. Following are brief descriptions of some of these key employee benefit obligations incurred by airlines and any unique attributes of those obligations.

Workers' Compensation

5.40 WC laws are designed to ensure that employees who are injured or disabled on the job are provided with fixed monetary awards, eliminating the need for litigation. These state laws also provide benefits for dependents of those workers who are killed because of work-related accidents or illnesses. Some laws also protect employers and fellow workers by limiting the amount an injured employee can recover from an employer and by eliminating the liability of coworkers in most accidents. State WC statutes establish this framework for most employment.

5.41 As in the manufacturing industry, the rate of WC incidents is high in the airline industry. As a result, many airlines incur substantial WC claim payments and record a large WC expense. Airlines frequently self-insure for some level of WC claims and maintain umbrella coverage over that amount. Airlines with significant self-funded plans can have significant collateral deposit requirements to support the estimated claims anticipated under their WC plan. Sometimes airlines use off-shore insurance companies to help minimize collateral requirements and provide certain tax benefits. The accounting for a fully self-insured or partially self-insured WC involves significant judgments and estimates by senior management. Airlines should consider guidance in FASB ASC 450-20-25 when determining accruals for self-insured WC. Airlines should also consider obtaining estimates from actuaries for significant WC accruals.

Severance Benefits

5.42 Severance or termination benefits may take various forms, including lump sum payments, periodic future payments, or both. They may be paid directly from an airline's assets, an existing pension plan, a new employee benefit plan, or a combination of those means. Which guidance is applicable to severance or termination benefits depends on the nature of the severance plan, as follows:

- FASB ASC 712-10-25 sets forth the accounting for special termination benefits offered for a short period or contractual termination benefits required by the terms of a plan if a specified event occurs and severance benefits paid under a contractual provision (typically for union employees) or pursuant to an established plan.
- FASB ASC 420-10-25-4 sets forth guidance on accounting for termination benefits provided to employees who are terminated involuntarily under the terms of a benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract (for example, a one-time severance benefit).

5.43 FASB ASC 420-10-30-6 provides that, if employees are required to render service until they are terminated in order to receive termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits should be measured initially at the communication date based on the fair value of the liability on the termination date. Per FASB ASC 420-10-25-9, the liability for the termination benefits should be recognized ratably over the future service period.

5.44 This practice is common in the airline industry because an immediate reduction in work force would be disruptive to operations due to training issues associated with pilots and, to a lesser extent, flight attendants and mechanics.

5.45 However, a special termination benefit offered to employees should be recognized as a liability and a loss in the period that the offer is accepted and the amount can be reasonably estimated in accordance with FASB ASC 712-10-25-1.

5.46 Severance benefits paid in accordance with union contract provisions would be accounted for in accordance with FASB ASC 710-10-25-1 if the obligation is attributable to employees' services already rendered, employees' rights to those benefits accumulate or vest, payment of the benefits is probable, and the amount of the benefits can be reasonably estimated. If those four conditions are not met, the employer should account for severance benefits in accordance with FASB ASC 450-20-25-2, which states that an estimated loss should be accrued by a charge to income, in the period in which (*a*) based on information available before the financial statements are issued or are available to be issued, it is probable that a liability has been incurred at the date of the financial statements and (*b*) the amount of loss can be reasonably estimated. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

5.47 Therefore, a thorough understanding of the severance benefit offered is essential in order to determine the appropriate accounting.

Pilot Disability (Permanently or Medically Grounded)

5.48 Grounding of a pilot can occur for medical reasons such as poor eyesight, physical disabilities, or heart conditions. Most pilots' CBA contracts call for a salary continuation benefit that is based on a percentage of the pilot's average earnings over a specified period. Disability benefits are generally accounted for in accordance with FASB ASC 712-10-25.

Voluntary Furloughs

5.49 Certain work group contracts have provisions that permit employees to accept voluntary furloughs in lieu of furloughing other employees who would generally be furloughed on a seniority basis. Airlines accept the voluntary furlough programs because they generally result in furloughing slightly higher compensated employees than would be furloughed in the event of a seniority based furlough. As an incentive to accept the voluntary furloughs, employees typically receive medical, dental, and certain other benefit coverages during the furlough period. The cost of these benefits would generally be accrued when the voluntary furlough is accepted. In addition, it is necessary to consider the effect of these furloughs on accounting estimates for pensions and other postemployment benefits.

Flight Crew Payroll

5.50 The pay of flight personnel (pilots and flight attendants) normally represents the largest portion of an airline's salaries expense. The pay is usually determined collectively based on the rates specified in the CBA and generally depends on a number of variables including, among others, number of hours flown, the type of equipment flown, whether the hours flown were day or night hours, seniority, and flying status (for example, pilot, first officer, flight engineer, or flight attendant). Crew members are also reimbursed a daily per diem for each day away from their assigned home base.

Inherent Risk Factors

5.51 Factors that influence inherent risk in the compensation and benefit areas might include the following:

- Subjectivity in judgments and estimates associated with amendable labor contracts
- Lengthy period during which a contract is amendable
- Significant management judgment and estimates related to the actuarial process to calculate pension, postretirement, postemployment, and self-insured WC expense
- Economic downturns that might result in the airline making significant changes to its benefit plan offerings (conversion of a defined benefit plan)
- Changes and enhancements to employee benefits
- Effect on benefits for a financially distressed airline (for example, reductions in force)
- Changes in broad economic assumptions

Chapter 6

Other Accounting Considerations

Intangible Assets

6.01 Intangible assets, either acquired or developed internally, may include the following: international route authorities (routes), airport landing and take-off rights (slots), airport operating rights, frequent flyer agreements, customer base, international alliance agreements, code-share agreements, trade names, and vendor contracts. When airport gates are acquired in a transaction that is not part of a business combination, the value of the gates is usually recorded separately. However, when acquired as part of a business combination, gates would generally be valued as a component of airport operating rights except to the extent that the underlying lease qualifies as a contractual intangible (that is, a favorable lease).

6.02 Currently, the unique intangible assets in the airline industry are primarily domestic slots, airport operating rights, and international route authorities and slots.

Domestic Assets

Domestic Slots

6.03 In 1968, the Federal Aviation Administration (FAA) introduced the High Density Traffic Airports rule that established a fixed number of take-off and landing rights at certain very high density airports (including New York John F. Kennedy International [JFK], New York LaGuardia, Washington Reagan National, and Chicago O'Hare) to avoid excessive congestion and to reduce delays. These slots were initially granted to the incumbent airlines, but they can be leased, traded, or sold on an individual or overall basis at each airport. In March 2000, the Wendell H. Ford Aviation Investment and Reform Act was passed, resulting in the elimination of slot restrictions at O'Hare on July 1, 2002, and at LaGuardia and JFK on January 1, 2007. The legislation does not provide for elimination of slots at Reagan airport. Although slot restrictions were eliminated at JFK in January 2007, in December 2007, an agreement had been reached between the Department of Transportation (DOT) and domestic airlines to ease congestion at JFK by shifting the timing of certain flights. In order to remedy congestion at LaGuardia that was exacerbated by the elimination of slot restrictions, the FAA placed caps on total operations and required carriers at LaGuardia to hold operating authorizations. With respect to O'Hare, in 2006, the FAA issued an order requiring carriers to hold arrival authorizations to land during certain hours at that airport. As regulations in this area continue to evolve, carriers need to carefully evaluate their effect on accounting for slots.

Airport Operating Rights

6.04 Airport operating rights represent the value of a carrier's established operations at airports that have certain attributes. Generally, this intangible asset exists at airports that have some or all of the following characteristics: significant barriers to entry exist at the airport, the airport is capacity constrained, or an airline has a substantial portion of the airport's capacity. An

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example would be an airline's operations at either its hub location or at a high density, capacity-constrained airport that is not slot controlled. Separately identifiable slot intangible assets and certain gate lease valuation intangibles would be recorded as separate intangibles and not as a component of airport operating rights.

6.05 According to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, an asset is *identifiable* if it meets either of the following criteria: (*a*) it is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so, or (*b*) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

6.06 In accordance with the definition of identifiable as presented in the preceding paragraph, airport operating rights should be recognized as a free-standing intangible apart from goodwill when the asset arises from contractual or other legal rights or if it is separable from the airline. Typically, airport operating rights meet the separability criteria of being identifiable because the airline's underlying operations at the airport can be sold or leased in a separate transaction.

6.07 Airport operating rights may be developed internally by the airline through expansion of its operations at an airport, or they may be acquired individually or in a business combination. The fair value of airport operating rights is driven by market conditions, locations, and other factors and is generally determined using an income approach.

Accounting Treatment

Valuation

6.08 An airline may have received the bulk of its slots at any given airport through its historical operations, by acquiring them (either from another airline or through a business combination), or by recognizing them through the application of fresh start accounting as required by paragraphs 19–21 of FASB ASC 852-10-45, which is discussed in "Bankruptcy Matters" in this chapter.

6.09 Consistent with FASB ASC 350-20-25-3, the cost of internally developed airport operating rights should be expensed as incurred.

6.10 Domestic slots and airport operating rights that are acquired (either from another airline or through business combinations) or recognized through the application of fresh start accounting are capitalized and amortized over their useful life or assigned a finite life depending on the significance of the airlines presence at the airport. Slots and airport operating rights acquired in an asset purchase or business combination are recognized at their fair value as required by FASB ASC 805-20-30-1, which states that the acquirer should measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values. As required by FASB ASC 805-10-50-2, if comparative financial statements are presented, the pro forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period only, including a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings.

6.11 Airlines occasionally acquire domestic slots and airport operating rights through an exchange with other airlines involving either similar assets or similar assets and cash. These exchanges should be accounted for in accordance with FASB ASC 845-10-25-1, which states that a reciprocal transfer of a nonmonetary asset should be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred and FASB ASC 845-10-30-1, which states that the accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange.

6.12 Nonmonetary exchanges are typically recorded at fair value unless the exchange lacks commercial substance or certain other considerations as described in FASB ASC 845-10-30-3.

6.13 FASB ASC 845-10-30-4 states that a nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange.

6.14 The airline would evaluate the exchange to determine if the airline's future cash flows are expected to change significantly as a result of the exchange. If the exchange lacks commercial substance, the intangibles received are recognized at the recorded amount of the relinquished assets.

6.15 Domestic slots and airport operating rights have been traditionally considered to be finite-lived assets based on their close association to the related airport infrastructure, including leases and other operating or use agreements.

6.16 FASB ASC 350-30-35-2 states that the useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. The useful life is not the period of time that it would take that entity to internally develop an intangible asset that would provide similar benefits. However, a reacquired right recognized as an intangible asset is amortized over the remaining contractual period of the contract in which the right was granted. If an entity subsequently reissues (sells) a reacquired right to a third party, the entity includes the related amortized asset, if any, in determining the gain or loss on the reissuance. Additionally, FASB ASC 350-30-35-3 provides guidance on pertinent factors to analyze when considering the useful life of an intangible asset.

6.17 The following factors are considered in determining the useful life of domestic slots and airport operating rights:

- The accelerated pace of change in the airline industry and the effects of competition among airports
- Legislative action that results in an uncertain regulatory environment as it relates to slots and their expected termination date

- The terms of existing facility leases at airports and the airline's own historical experience and expectations about renewing these leases
- Statutory lives, if any, for slots

6.18 In certain cases, airlines may assign lives longer than those specified in the lease or other statutory or contractual provisions. In these cases, airlines have concluded that significant continuing value exists at these locations (due to significant capacity constraints at the airport, barriers to entry, or the airline's having a substantial portion of the airport's capacity), which would compel them to remain at the location past contractual periods. See "Amortization of Leasehold Improvements" in chapter 4, "Acquiring and Maintaining Property and Equipment," for a discussion of criteria that are applied in determining the lives of leasehold improvements. These criteria would also be considered in determining useful lives of intangible assets related to airport operations.

Impairment

6.19 Finite-lived intangible assets are assessed for impairment using the undiscounted cash flow methodology as discussed in FASB ASC 360-10-35-17.

6.20 FASB ASC 360-10-35-23 states that for purposes of recognition and measurement of an impairment loss, a long-lived asset or assets should be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.

6.21 Identifying the group of assets at which cash flows are largely independent requires judgment. For example, an airline might conclude that the airport to which the asset relates provides the lowest level of identifiable cash flows. Alternatively, an airline also might conclude that the airport to which the asset relates would not provide the lowest level of identifiable cash flows. This is because the cash flows from airport operating rights are largely dependent on cash flows from airline operations (that is, transportation of passengers), and using the cash flows at the airport level would involve a high degree of allocation. Therefore, for impairment testing purposes, airport operating rights would be a part of a larger asset group and would be evaluated at a higher level than the airport.

Gates

6.22 A gate is recorded as a separate asset if the right to use the gate is acquired from another airline. The gate is recorded based on the amount paid to obtain the right to use the gate or the fair value of the asset exchanged. The fair value of the gate lease also needs to be considered because if there is a difference between the recorded value of the gate and the fair value of the lease, it may indicate the existence of another asset. The value of gates does not include any leasehold improvements. The life assigned to the gate is generally the remaining term of the lease or the sublease from the other airline. As described in "Amortization of Leasehold Improvements" in chapter 4, in limited circumstances, the airline may conclude that the useful life of leasehold improvements is longer than the contractually stated lease term for the related airport facility. When airport gates are acquired as part of a business combination, gates would generally be valued as a component of airport operating rights except to the extent that the underlying lease qualifies as a contractual intangible (that is, a favorable lease).

International Route Authorities and Slots

6.23 Access to foreign markets by U.S. registered carriers has historically been subject to bilateral agreements between the U.S. government and governments of foreign countries. These agreements can restrict access to U.S. gateway cities and foreign destinations by limiting the number of airlines that may provide service to certain airports, restrict service to certain airports, restrict types of aircraft, limit frequencies of flights, or limit the beyond flying capabilities of the carrier. These bilateral agreements provide that the route certificates are awarded by the U.S. government to the individual carriers on a temporary basis and that they can be renewed upon expiration by the DOT.

6.24 Administratively, the route certificate is considered a license for continuing activity and is renewed by the incumbent carrier based on the filing of a timely application combined with meeting a certain level of service. If a carrier files timely for renewal of its route authority and the DOT takes no action, the carrier's authority is extended by the applicable provisions of the law. DOT regulations include an affirmative rebuttable presumption standard in favor of renewal of the incumbent carrier's route certificate upon expiration of the certificate, and applications for renewal of route certificates by the incumbent carriers have been approved in virtually all cases.

6.25 Traditionally, foreign countries limited the access to routes from the United States to only a single or a few U.S. carriers and also frequently limited the destinations within the United States that could be operated. That was done initially to protect the foreign countries' national carriers from competition. The more restrictive the access to a country or region (that is, the rights to fly to a country with beyond rights into other countries), the more valuable the route authority is to the carrier. In the 1980s and 1990s, as international travel boomed, distressed carriers sold their route authorities into various countries, either individually or in the aggregate. Because new authorities would rarely be granted, a carrier that wanted to start operations to a new country had no choice but to acquire the route authority from another carrier.

6.26 Route authorities traditionally have also designated the airport to which the airline may operate. Just as the value in a route authority is driven by restrictive access to a particular country or region, a significant portion of value can be derived from access to a restricted airport. Practice to date has viewed the right to fly between two countries (route authority) and the right to land at the international airport at a specific time (slot) as one asset or one asset group because the route authority and the slots are interdependent. In certain countries, however, slots are separable from the underlying route authority. The treatment of international slots varies based on the country or region in which the airport is located. For instance, slots do not formally exist in Latin America. An airline having appropriate operating authority pursuant to a bilateral agreement notifies the airport of its intent to operate the route and then works with the airport authority to determine an acceptable landing time. In addition, there is no history or experience of airlines being able to swap or trade these slot times independent of the related route authority.

Therefore, these slots were simply considered to be either a specific component of the route authority or a procedural agreement with the airport that had no independent value. In the United Kingdom (UK) and other European Union (EU) member countries, slots are generally separable from the route authority and are administered by an independent coordinator at each airport. This practice developed over the years as the demand for slot times at high density airports increased. In the UK, a market exists for the transfer or monetization of slots, whereas in the rest of the EU member countries, monetization of the slots is not permitted. Slots in the EU can be transferred but for no value, except that they generally can be transferred along with other assets. In Japan and China, slots are separable assets but cannot be transferred apart from the route authority. Although slots are not transferable in Japan, carriers operating under the same bilateral treaty can use each other's slots (for example, under the U.S.-Japan bilateral agreement, United Airlines may use a Federal Express slot, but United Airlines and British Airways could not use each other's slots). Slots do not require renewal, although they are subject to a "use or lose" test, and the airlines have legal title to the slots.

Open Skies

6.27 Since the 1990s, the U.S. government has pursued a policy of "open skies" under which it has negotiated a number of bilateral agreements allowing unrestricted access to foreign markets. Historically, the markets in certain countries (most notably, Heathrow and Gatwick in the UK and Japan and China) have remained subject to restrictive bilateral agreements. The United States and the EU signed an open skies agreement that became effective on March 30, 2008. Under the terms of this agreement, any European carrier is allowed to fly to any city in the United States, and U.S. carriers are granted access to all airports in the 27-nation EU. In December 2009, the United States and Japan reached an open skies agreement, subject to approval of anti-trust immunity from the U.S. Department of Transportation and Japan's Ministry of Land, Infrastructure, Transportation and Tourism. However, even in an open skies country, a carrier must still acquire a route certificate and related airport access to operate to a specific destination within that country.

Effect of Open Skies on the Existence of an Asset

6.28 The AICPA Financial Reporting Executive Committee (FinREC) believes that the effect of an open skies agreement on international routes and slots will depend on the nature of the recorded asset prior to the advent of the open skies environment, that is, whether an airline recorded routes and slots as separate assets or combined them as a single asset. Over the years, airlines have typically acquired or recorded asset values for routes and related slots in different types of transactions, which can be described as follows:

- *Acquisition of a combined asset.* In periods prior to open skies, airlines typically acquired routes and related slots as part of a combined asset and recorded the acquired assets as one asset, generally referred to as a *route authority*.
- *Acquisition of individual assets.* Occasionally, airlines acquired slots without routes and, on a much more limited basis, routes without the related slots in separate transactions and recorded them as separate assets.

- *Business combination or application of fresh start reporting.* In a business combination or as a result of the application of fresh start reporting, an airline either recorded routes and slots as individual assets or as a combined asset for a particular country or airport location within a country.

6.29 In periods prior to open skies most recorded international intangible assets represented the combined assets (routes and slots) and were generally considered indefinite-lived intangible assets.

6.30 Ratification of open skies agreements has a significant effect on routes and slots. Effectively, a route after open skies has little or no value due to the elimination of substantially all restrictions on acquiring that asset, and a slot in a capacity controlled environment contains substantially all of the value because it represents the right that restricts access to the airport or country location. As indicated previously, the accounting after open skies depends on whether in the original transaction an airline recorded routes and slots as separate assets or combined them as a single asset and can be summarized as follows:

- *Combined asset.* If a route and related slot were recorded as a single combined asset in the initial transaction, FinREC believes that the combined asset still exists and would be subject to impairment testing based on the combined value of the route and slot. Although the route itself has little or no value after the advent of open skies, an impairment may not exist because the value derived from the slot restrictions may be sufficient to recover the combined intangible asset. See "Impairment" in this chapter for further discussion regarding impairment testing.
- *Individual assets.* There are two views on whether individually recorded routes continue to meet the definition of an asset after open skies. Some FinREC members believe that such routes no longer meet the definition of an asset because open skies agreements eliminate restrictions on the number of airlines that can be granted a route. Accordingly, these FinREC members believe that the value associated with such routes should be charged to expense, and the related slots should be evaluated for impairment. The alternative view is that such separately recorded routes continue to meet the definition of an asset in an open skies environment. Under this view, separately recorded routes and slots need to be tested for impairment based on the guidance in FASB ASC 360-10-35 and FASB ASC 350-30-35-21 as discussed in "Impairment" in this chapter.
- *Business combination or application of fresh start reporting.* For assets that were recorded as part of a business combination or as a result of the application of fresh start accounting, the accounting after open skies is based on whether these assets were recorded as individual or combined assets as discussed previously.

Useful Life

6.31 The discussion in this section pertaining to separately recorded routes assumes that the airline has concluded that the asset continues to exist after open skies. Airlines that believe that separately recorded routes no longer meet the definition of an asset in an open skies environment would write off this asset and, therefore, would not need to reassess its useful life. These airlines, however, would still evaluate the useful life of separately recorded slots and combined assets as discussed in the following paragraphs.

6.32 Prior to an open skies environment, combined assets, separately recorded routes, and separately recorded slots in countries with restrictive bilateral agreements generally have been assigned an indefinite life, as discussed in "Effect of Open Skies on the Existence of an Asset."

6.33 According to FASB ASC 350-30-35-16, an entity should evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life.

6.34 FASB ASC 350-30-35-17 states if an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset should be tested for impairment in accordance with paragraphs 18–19 of FASB ASC 350-30-35, as discussed in "Impairment" in this chapter.

6.35 In determining whether its international intangible assets have a finite or indefinite life, the airline should follow the guidance in FASB ASC 350-30-35-2, which states that the useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity.

6.36 FASB ASC 350-30-35-4 states that if no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset should be considered to be indefinite. The term *indefinite* does not mean the same as *infinite* or *indeterminate*. The useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon—that is, there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity, such as airport route authorities.

6.37 In determining whether a separately recorded international route, slot, or combined asset has an indefinite or finite useful life, airlines need to consider and evaluate in particular the following factors described in FASB ASC 350-30-35-3, which are used to determine the useful life of the asset, with no one factor being more presumptive than the other:

- The expected use of the asset by the entity.
- The expected useful life of another asset or group of assets to which the useful life of the intangible asset may relate.
- Any legal, regulatory, or contractual provisions that may limit the useful life. The cash flows and useful lives of intangible assets that are based on legal rights are constrained by the duration of those legal rights. Thus, the useful lives of such intangible assets cannot extend beyond the length of their legal rights and may be shorter.
- The entity's own historical experience in renewing or extending similar arrangements consistent with the intended use of the asset by the entity, regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of that experience, the entity should consider the assumptions that market participants would use about renewal or extension consistent

with the highest and best use of the asset by market participants, adjusted for entity-specific factors in this paragraph.

- The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels).

- The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

Further, if an income approach is used to measure the fair value of an intangible asset, in determining the useful life of the intangible asset for amortization purposes, an entity should consider the period of expected cash flows used to measure the fair value of the intangible asset adjusted as appropriate for the entity-specific factors in this paragraph.

6.38 In addressing whether any legal or regulatory provisions may limit the useful life of a separately recorded route or slot or a combined asset, specifically with regard to the movement toward open skies, FinREC believes the effect of open skies should be analyzed on a country-by-country basis. There are two views on whether the possibility of this regulatory change should affect the indefinite-lived status of these assets. Some FinREC members believe that airlines should not anticipate ratification of open skies in the future and would not consider it as a factor when evaluating the remaining useful life of these assets until open skies access is granted in the country to which the international route authority asset pertains. Other FinREC members believe that airlines should take into account all relevant factors and consider the likelihood of this regulatory change and its effect on the indefinite-lived status of separately recorded routes, slots, and combined assets before the actual ratification.

6.39 Prior to an open skies environment, the useful life of combined assets, separately recorded routes, and separately recorded slots in countries with restrictive bilateral agreements generally has been considered indefinite. FinREC generally believes that once an open skies agreement is effective, even though the cash flows may continue indefinitely, they will do so at a diminished level, thus, potentially resulting in an impairment and a reassessment of the useful life of these assets. Each particular situation needs to be evaluated based on its facts and circumstances; however, FinREC believes that international intangible assets may be more appropriately considered to be finite-lived assets.

6.40 Slot transition provisions (which may allocate slots to new airport entrants), existing and future terminal capacity at the airport, future runway construction, and the airline's operating intention with respect to the airport where the slots are located influence the airline's reconsideration of the useful life. Absent slot transition provisions, an airline may be able to support the indefinite-life status of separately recorded international slots and combined assets.

6.41 When evaluating the useful lives of its international intangible assets, an airline also needs to consider the lives of related asset groups or individual assets that support these assets, such as airport leases, airport infrastructure, and related aircraft.

Impairment

6.42 FASB ASC 350-30-35-18 requires that an intangible asset that is not subject to amortization should be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. FASB ASC 360-10-35-21 includes examples of impairment indicators.

6.43 Indefinite-lived intangible assets, including those that are subsequently determined to have a finite useful life, are assessed for impairment.

6.44 Paragraphs 18A–18F of FASB ASC 350-30-35 explain that an entity may first perform a qualitative assessment to determine whether it is necessary to perform the quantitative impairment test. An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test as described in the "Pending Content" in FASB ASC 350-30-35-19. An entity may resume performing the qualitative assessment in any subsequent period. If an entity elects to perform a qualitative assessment, it first shall assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired.

6.45 In assessing whether it is more likely than not that an indefinite asset is impaired, an entity should assess all relevant events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived asset. Examples of such events and circumstances are given in the "Pending Content" in FASB ASC 350-30-35-18B.

6.46 The examples provided are not all inclusive and an entity should consider other relevant events and circumstances that could affect the significant inputs used to determine the fair values of the definite-lived asset. An entity should consider the extent to which each of the adverse events and circumstances identified could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset. An entity also should consider the following to determine whether it is more likely than not that the indefinite-lived asset is impaired

- positive and mitigating events and circumstances that could affect the significant inputs used to determine the fair calue of the indefinite-lived intangible asset.
- if an entity has made a recent fair value calculation for an indefinite-lived asset, the difference between that fair value and the then carrying amount.
- whether there have been any changes to the carrying amount of the indefinite-lived intangible asset.

6.47 An entity should evaluate, on the basis of the weight of the evidence, the significance of all identified events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset for determining whether it is more likely than not that the indefinite-lived intangible asset is impaired. The existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the quantitative impairment test as described in the "Pending Content" in FASB ASC 350-30-35-19.

6.48 If after assessing the totality of events and circumstances and their potential effect on the significant inputs to the fair value determination, and entity determines that it is more likely than not that the indefinite-lived asset is not impaired, then the entity need not calculate the fair value of the intangible asset and perform the quantitative impairment test. If however, the entity does determine that it is more likely than not that the asset is impaired, then the entity should calculate the fair value and perform the quantitative impairment test in accordance with the following paragraph.

6.49 Further, the "Pending Content" in paragraphs 19–20 of FASB ASC 350-30-35 state that the quantitative impairment test should consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss should be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset should be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

6.50 Airlines should consider the guidance in paragraphs 21–28 of FASB ASC 350-30-35, in determining the unit of accounting to use in impairment testing.

6.51 When testing separately recorded international routes and slots for impairment and applying paragraphs 21–28 of FASB ASC 350-30-35, an airline will need to determine whether to treat these assets as a single unit of accounting or evaluate them separately. Based on the analysis of indicators in paragraphs 21–28 of FASB ASC 350-30-35, the following factors would support treating routes and slots as a single unit of accounting for impairment testing purposes:

- International route authorities were either issued to or acquired by airlines as one asset (the slots were a component of the route authority), or the route and slots were acquired separately but subsequently used together prior to the advent of open skies.
- The route at an airport has little or no value without the slots, and vice versa.
- The requirement to have both assets (route and slots) at a specific location in order to operate the flight.
- The route and slots have traditionally been sold together.
- Integration of cash flows from routes within a region, that is, the need to fly to a specific city in order to operate fifth freedom rights from that city.

6.52 However, the following factors would support *not* treating international route authorities and slots as a single unit of accounting for impairment testing purposes:

- Recently, route authorities to certain locations have been sold independently of slots, and slots have been sold or leased independently of the related routes.

- Open skies might limit the useful economic life of routes but would not similarly limit the useful economic life of slots.

6.53 In applying paragraphs 21–28 of FASB ASC 350-30-35 to routes and slots that were acquired separately, the airline would consider that separate acquisition of these assets implies the existence of a market for the individual assets in that particular location, and that these assets may potentially need to be evaluated for impairment separately under the provisions of paragraphs 21–28 of FASB ASC 350-30-35. Airlines that have adopted the view that after open skies individually recorded routes will no longer meet the definition of an asset would charge the value associated with such routes to expense instead of testing them for impairment and would evaluate the related slots for impairment. The following examples illustrate the application of paragraphs 21–28 of FASB ASC 350-30-35 to situations in which routes and slots were acquired in separate transactions and recorded as individual assets:

- *Routes and slots that were acquired in separate transactions but subsequently used as a combined asset prior to the advent of open skies.* In these situations, generally the combined asset, and not the individual components, would be evaluated for impairment.
- *A route that was acquired in a separate transaction and not used with a slot (generally this would occur only when an airport has no slot time restriction).* In this example, application of paragraphs 21–28 of FASB ASC 350-30-35 would generally result in the route asset being evaluated for impairment on an individual basis. FinREC believes that in an open skies environment, the individual route would likely be fully impaired in this situation because routes can now be obtained at little or no cost and, as a result, their fair value is either zero or minimal.
- *Routes and slots that were acquired in separate transactions and that have different useful lives.* In an open skies environment, an airline may conclude that the route is a finite-lived asset, whereas the slot is still an indefinite-lived asset as discussed in "Useful Life" in this chapter. Based on the guidance in paragraphs 21–28 of FASB ASC 350-30-35, different useful lives would preclude these assets from being evaluated for impairment on a combined basis. As a result, the route and the slot would be evaluated for impairment on an individual basis.

6.54 The preceding examples are not intended to cover all possible scenarios and outcomes. Accordingly, specific facts and circumstances need to be evaluated carefully to ensure that paragraphs 21–28 of FASB ASC 350-30-35 are applied properly.

Finite-Lived International Intangible Assets

6.55 International intangible assets with finite useful lives should be tested for impairment in accordance with FASB 350-30-35-14 and FASB ASC 360-10-35-23, as discussed in "Accounting Treatment" in the "Domestic Assets" part of this chapter. Furthermore, if there are indications that a finite-lived intangible asset may be impaired, the airline may also need to reassess the useful life of the asset.

Inherent Risk Factors

6.56 Factors that influence inherent risk related to intangible assets might include the following:

- Changes in bilateral agreements and their effects on route valuations
- Frequent changes in the airline routes, pricing structures, or operations
- Recent changes in the regulatory environment at domestic airports
- The financial difficulties of the airline industry
- The complexity of determining the fair value of intangible assets for purchase price allocation and impairment purposes

Bankruptcy Matters

6.57 Over the years, a significant number of airlines have been forced to seek protection under Chapter 11 of the United States Bankruptcy Code to continue operations or have completed structured reorganizations to avoid a bankruptcy filing.

6.58 Readers should refer to FASB ASC 852, *Reorganizations*, for guidance on accounting while in bankruptcy. A description of the application of certain provisions of FASB ASC 852 in the airline industry follows.

Statement of Operations

6.59 The major change to an airline's statement of operations upon filing for reorganization under Chapter 11 of the United States Bankruptcy Code is the addition of a line item or a section titled "Reorganization Items." FASB ASC 852-10-45-9 states that revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business should be reported separately as reorganization items, except for those required to be reported as discontinued operations and extraordinary items in conformity with FASB ASC 205-20 and FASB ASC 225-20.

6.60 If reorganization items are presented as a single line item, the airline needs to disclose the components in the notes to its financial statements. Although FASB ASC 852 is unclear about whether the reorganization items should be presented in the "nonoperating" or "operating" section of the statement of operations, nonoperating has traditionally been the most common classification in the airline industry. Reorganization items may include the following:

- Estimated allowed claims for aircraft rejections
- Gains and losses on forgiveness of debt and allowed claims
- Rejection of special facility bonds
- Professional fees

6.61 An aspect of bankruptcies in the airline industry is Section 1110 of the United States Bankruptcy Code, which allows an automatic stay of 60 days with respect to paying interest or rent on qualifying aircraft. The debtor may extend the 60-day period through agreements with creditors and approval of the bankruptcy court. During this period, the debtor may decide to perform fully under the lease or debt obligations, may negotiate with creditors for more favorable terms, or may ultimately decide to reject and return the aircraft to the creditor.

6.62 Before secured debt obligations related to Section 1110 aircraft are confirmed (that is, approved by the bankruptcy court as part of a plan of reorganization under a Chapter 11 proceeding, which makes it binding on the debtors and creditors), current practice is to accrue interest expense at the contractual rates in effect prior to the bankruptcy filing until the airline has resolved uncertainties regarding which debt obligations will be rejected or accepted and which debt obligations are either fully collateralized or undersecured.

6.63 FASB ASC 852-10-45-11 states that interest expense should be reported only to the extent that it will be paid during the bankruptcy proceeding or that it is probable that it will be an allowed priority, secured, or unsecured claim. Interest expense is not a reorganization item.

6.64 Therefore, if at a certain point the airline concludes that it is not probable that interest will be an allowed claim, the accrued interest liability may be adjusted to the expected amount of the allowed claims in accordance with the requirements of FASB ASC 450-20-25-2.

6.65 Leases are considered executory contracts, and obligations related to leases prior to filing for bankruptcy are considered prepetition liabilities. According to the FASB ASC glossary, *prepetition liabilities* are liabilities that were incurred by an entity before its filing of a petition for protection under the Bankruptcy Code including those considered by the bankruptcy court to be prepetition claims, such as a rejection of a lease for real property. For aircraft rent obligations, the debtor would continue to accrue aircraft rent expense until a determination is made that the aircraft will be rejected. Claims resulting from the rejection of a lease, such as rent obligations covering the stay period, are considered prepetition liabilities and are discussed in "Rejected Aircraft" that follows in this chapter.

6.66 FASB ASC 852 provides that prepetition liabilities should be reported on the basis of the expected amount to be allowed by the bankruptcy court in accordance with the requirements of FASB ASC 450-20-25-2, as opposed to the amounts for which those allowed claims may be settled. FASB ASC 450-20-25-2 provides that a liability should be recognized when a loss contingency is both probable and reasonably estimable.

Rejected Aircraft

6.67 Claims related to aircraft lease rejections are considered prepetition liabilities and would be reported at the estimated amounts of the allowed claims once the claims are probable and reasonably estimable, which would generally be when the aircraft rejection is approved by the bankruptcy court. The claims are recognized in reorganization expense. When leased aircraft are rejected, any leasehold improvements, deferred gains on sale-leaseback transactions, and maintenance or other deposits forfeited are written off as reorganization expenses. If aircraft pledged as collateral on debt arrangements are rejected in accordance with the provisions of the bankruptcy code, no gain or loss associated with the extinguishment of indebtedness would be recognized until the debtor is legally released from its obligation, which happens upon approval of the rejection by the bankruptcy court.

Balance Sheet

6.68 Paragraphs 4–8 of FASB ASC 852-10-45 provide specific guidance for the preparation of the balance sheet during the reorganization period.

6.69 Liabilities incurred during the 60-day stay period are generally considered prepetition liabilities or administrative claims. Per FASB ASC 852-10-45 liabilities subject to compromise (which include all prepetition liabilities, or claims, except those that will not be impaired under the plan, such as claims that are fully secured) should be separated from those that are not and from postpetition liabilities (which are incurred subsequent to the filing of a petition and are not associated with prebankruptcy events).

6.70 In an airline's financial statements, liabilities subject to compromise are presented between current and noncurrent liabilities. The following are examples of liabilities generally not covered by first-day orders (various emergency or expedited motions and orders that are filed on or shortly after the filing of the Chapter 11 petition, the purpose of which is to deal with administrative matters and to ensure that the debtor's business and operations are stabilized and conducted in a manner consistent with past practice and the proposed plan of reorganization, pending consideration of confirmation of that plan) that would be reclassified into liabilities subject to compromise:

- Unsecured debt
- Undercollateralized debt
- Certain litigation and environmental claims
- Accounts payable
- Accrued rent
- Accrued interest
- Deferred gains and credits related to sale and leaseback of aircraft
- Dividends payable
- Manufacturer's credits

6.71 The following liabilities are typically affirmed by the airline as part of first-day orders and are not included in liabilities subject to compromise:

- Unearned revenue
- Frequent flyer liabilities
- Accrued wages and benefits, including vacation accrual
- Tax withholdings
- Foreign payables

6.72 In addition, the ultimate disposition of any amounts of intercompany debt or receivables in stand-alone subsidiary financial statements will need to be addressed based on the bankruptcy court's rulings with regard to the validity of such arrangements. When determining how to display such items in the balance sheet during reorganization, airlines would need to consider the substance of the arrangements, classification in the financial statements prior to entering bankruptcy (for example, asset versus contra equity), and the status of the claim.

6.73 FASB ASC 470-50-40-2 states that if upon extinguishment of debt the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges should be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

Fresh Start Accounting and Reporting

6.74 Once a plan of reorganization has been approved by the bankruptcy court and the debtor is ready to emerge from under the protection of bankruptcy, the debtor needs to determine if fresh start accounting is appropriate. Traditionally, airlines have been required to apply a fresh start reporting model because they meet both of the conditions for fresh start reporting as specified in FASB ASC 852-10-45-19.

6.75 FASB ASC 852-10-45-19 explains that if the reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity, the entity should adopt fresh-start reporting upon its emergence from Chapter 11.

6.76 FASB ASC 852-10-45-20 provides requirements for the reporting of assets and liabilities under fresh start accounting. This guidance indicates that the reorganization value of the entity should be assigned to the entity's assets and liabilities in conformity with the procedures specified by FASB ASC 805-20 If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts should be reported as goodwill in accordance with FASB ASC 350-20-25-2.

6.77 Per FASB ASC 852-740-45-1, for entities that meet the FASB ASC 852-10-45-19 requirements for fresh-start reporting, deferred taxes should be reported in conformity with U.S. generally accepted accounting principles (GAAP). If not recognizable at the plan confirmation date, initial recognition (that is by the elimination of the valuation allowance) of tax benefits realized from preconfirmation net operating loss carryforwards and deductible temporary differences should be reported as a reduction to income tax expense.

6.78 Airline-specific fair value considerations for assets and liabilities include the following areas:

- *Assets*—(*a*) routes, slots, and airport operating rights and (*b*) other intangibles
- *Liabilities*—(*a*) air traffic liability[1] and (*b*) frequent flyer liabilities

6.79 The effects of the previously listed fresh start adjustments on the reported amounts of individual assets and liabilities and the effects of the debt extinguishment resulting from the adoption of fresh start accounting are

[1] The extent to which the fair value and carrying value of air traffic liability differ is largely dependent upon the amount of unrecognized breakage (as discussed in chapter 3, "Marketing, Selling, and Providing Transportation") and the amount of profit, if any, associated with selling effort.

recorded in the predecessor airline's statement of operations (that is, prior to emergence from bankruptcy). The adoption of fresh start accounting results in the adjustment of stockholders' equity based upon the reorganization value of the airline.

Inherent Risk Factors

6.80 Factors that influence inherent risk related to bankruptcy might include the following:

- The complexity of airline bankruptcies
- The unique nature of certain assets and liabilities that require fair value calculations for fresh start accounting
- The volume of aircraft financing transactions
- The judgment required in determining expense classification (reorganization or operating)
- The unique nature of certain airline obligations

Guarantees and Indemnities

6.81 Paragraphs 1–2 of FASB ASC 460-10-05 explain that FASB ASC 460, *Guarantees*, establishes the accounting and disclosure requirements to be met by a guarantor for certain guarantees issued and outstanding and addresses the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee, and requires certain disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FASB ASC 460-10-25 clarifies the requirements related to the recognition of a liability at the inception of a guarantee and FASB ASC 460-10-35 discusses recognition of the fair value of the obligation undertaken in issuing the guarantee.

6.82 In the airline industry, guarantees and indemnities are common and take many forms. A few examples of guarantees in the airline industry include a parent's guarantee of its subsidiary's third-party debt or operating lease payments, guarantees contained in lease agreements, and guarantees of indebtedness of others.

6.83 FASB ASC 460-10-25-2 distinguishes between the noncontingent aspect of the guarantee (agreement by the guarantor to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur) and the contingent aspect of the guarantee (fulfillment of the guarantee if those triggering events or conditions occur). FASB ASC 460-10-25-3 explains that in situations in which recognition of a liability for the guarantee is required because the issuance of the guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, a liability for that guarantee should be recognized even though, based on guidance in FASB ASC 450-20-25, it is *not* probable that payments will be required under that guarantee. FASB ASC 460-10-30-2 states that the objective of the initial measurement of the liability for the guarantee is the fair value of the guarantee at its inception.

6.84 The airline needs to distinguish between guarantees requiring disclosure and guarantees requiring initial recognition. FASB ASC 460-10-25-1 and FASB ASC 460-10-15-7 contain lists of guarantees and indemnities that are excluded from its scope, whereas FASB ASC 460-10-50-2 lists guarantees that are not subject to its initial recognition and measurement requirements but are subject to its disclosure requirements.

Parent's Guarantee of Its Subsidiary's Third-Party Debt or Operating Lease Payments

6.85 An airline may issue debt or enter into a long-term operating lease in conjunction with which the airline's parent company guarantees the airline's performance. Because the parent company is guaranteeing the consolidated entity's own performance, the guarantee is not subject to the recognition, measurement, and disclosure provisions of FASB ASC 460 in the consolidated financial statements as stated in FASB ASC 460-10-25-1(g).

Guarantees Contained in Lease Agreements

6.86 Aircraft and equipment lease agreements typically contain residual value guarantees (RVG). Per FASB ASC 460-10-15-7(b) the guidance in FASB ASC 460 does not apply to a lessee's guarantee of the residual value of the leased property at the expiration date of the lease term, if the lessee (guarantor) accounts for the lease as a capital lease under FASB ASC 840-30.

6.87 FASB ASC 460 does not apply to RVG under leases that the lessee accounts for as capital leases (because the accounting for a capital lease under FASB ASC 840-30-35-1(b) includes the amount of RVG in the calculation of the lessee's recognized liability for its obligations under the capital lease). FASB ASC 460 does, however, apply to the recognition, measurement, and disclosure of RVG under leases that the lessee accounts for as operating leases.

6.88 Another common feature in an aircraft lease is a fixed price purchase option whereby the lessee has an option to buy the aircraft at a specified date prior to the end of the lease term or at the end of the lease term for a fixed percentage of the lessor's original cost of the aircraft. A fixed price purchase option is not a guarantee under FASB ASC 460 because the lessee is not obligated to acquire the aircraft in the event that the fair value of the aircraft drops below the fixed price.

Guarantees of Indebtedness of Others

6.89 Airlines frequently guarantee the indebtedness of others, such as a member of the airline's alliance or fuel consortium or a regional jet affiliate. In accordance with FASB ASC 460, this kind of guarantee requires recognition of the fair value of the airline's obligation to stand ready to perform under the guarantee. In practice, the value of a third-party guarantee could be based on present value differences between the terms of the debt that were available without the guarantee and the terms obtained with the guarantee. The contingent aspect of the guarantee—repayment of the debt by the airline in the event of default by the guaranteed party—should be accounted for using the recognition criteria of FASB ASC 450-20-25-2.

Inherent Risk Factors

6.90 Factors that influence inherent risk related to guarantees and indemnities might include the following:

- Complex nature of transactions in the airline industry
- Volume of agreements containing indemnities
- Difficulty in determining the fair value of certain indemnities and guarantees

Variable Interest Entities

6.91 A number of airlines have structures that need to be evaluated under the guidance of FASB ASC 810-10-25-20, to determine if they are variable interest entities (VIEs) and, if so, whether the airline is the primary beneficiary of the VIEs and needs to consolidate them. Examples of such structures include capacity purchase agreements, aircraft leases, enhanced equipment trust certificates (EETC), and airport fuel facilities. The lessors in airport facility leases that involve special facility revenue bond financings (discussed in "Airport Financings" in this chapter) are normally governmental entities. Governmental entities are scoped out by the guidance of FASB ASC 810-10-15-12. An airline should determine whether it is the primary beneficiary of a VIE at the time it becomes involved with the entity and should reconsider its conclusions regarding VIEs upon the occurrence of certain events listed in paragraphs 4–5 of FASB ASC 810-10-35 and paragraphs 39–41 of FASB ASC 810-10-25. Also, if, as a result of the airline's bankruptcy, agreements governing the relationship between the airline and VIE are modified, the airline needs to reevaluate its VIE decisions. Airlines need to prepare and maintain qualitative and, if necessary, quantitative evidence to support and provide rationale for their conclusions related to VIEs. The previous examples are not intended to be all inclusive, and the airline needs to evaluate all interests in entities for which one the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders and as a group, the holders of the equity investment at risk lack (*a*) the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (*b*) the obligation to absorb the expected losses of the entity, (*c*) the right to receive the expected residual returns of the entity, or (*d*) the equity investors have voting rights that are not proportionate to their economic interests, and substantially all of the activities of the entity involve or are conducted on behalf of an investor with disproportionately few voting rights.

Capacity Purchase Agreements

6.92 Capacity purchase agreements with regional airlines (which are discussed in detail in chapter 9, "Regional Airlines") should be evaluated under FASB ASC 810-10-25. A regional carrier may qualify for the business exclusion discussed in FASB ASC 810-10-15-17(d), eliminating the need for further analysis and application of the interpretation. However, if (*a*) the major airline participates in the redesign of the regional airline, (*b*) the regional airline receives significant financing from the major airline, or (*c*) the contract provides substantially all of its operations, the regional would not qualify for the business exclusion and would have to be evaluated by the major airline to determine whether it is a VIE. Also, regional capacity purchase agreements should be evaluated under FASB ASC 840-10-15. Chapter 9 discusses criteria that need to be considered when determining whether a capacity purchase agreement contains a lease.

Aircraft Leases

6.93 A traditional form of aircraft financing is lease financing, in which leasing trusts are established specifically to purchase, finance, and lease aircraft to the airlines. These leasing entities are potential VIEs. The typical leasing arrangements generally take the following forms: U.S. tax leases (leveraged leases from the lessor's perspective), single investor leases, multiple investor leases, or synthetic leases. The airline would need to evaluate its lease arrangements to determine if a variable interest exists. However, operating leases that do not include a residual value guarantee (or similar arrangement) or fixed price purchase option, and whose terms are consistent with prevailing market terms at the inception of the lease, are not considered variable interests in the lessor. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices are variable interests in the lessor entity if they meet the conditions described in paragraphs 56–57 of FASB ASC 810-10-25. Alternatively, such arrangements may be variable interests in portions of a VIE as described in FASB ASC 810-10-25-58. If a variable interest exists, the airline needs to determine if the lessor entity is a VIE based on the criteria in FASB ASC 810-10-15-14.

6.94 Paragraphs 38–44 of FASB ASC 810-10-25 provide guidance on consolidation based on variable interests. Based on these provisions, if the airline concludes that the entity is a VIE, which is generally the case with these arrangements, the next step is to determine whether the airline has a controlling interest in the VIE and is, therefore, the primary beneficiary of the entity. Paragraphs 38A–38G of FASB ASC 810-10-25 provide guidance on determining whether an enterprise has a controlling interest in a VIE. FASB ASC 810-10-50-4 requires an enterprise that holds a variable interest or interests in a VIE but is not the primary beneficiary to provide certain disclosures.

6.95 Generally, the fixed price early buyout option and the fixed price purchase option contained in lease agreements are the most common variable interests in the airline industry. They are considered variable interests because they entitle the airline to participate in increases in the value of the aircraft. Paragraphs 7–9 in "Pending Content" of FASB ASC 810-10-30 provide more guidance.

Enhanced Equipment Trust Certificates

6.96 Airlines finance new aircraft acquisitions through EETC structures (discussed in chapter 4 of this guide) that generally are VIEs because these structures contain multiple trusts that do not contain sufficient equity at risk. These structures can involve the airline assigning aircraft acquisition contracts to a financing trust, having the financing trust issue debt and equity, using the proceeds to acquire the aircraft, and then leasing the aircraft to the airline. Other structures involve the airline initially acquiring the aircraft through a debt or lease transaction and, at a later point, entering into an EETC transaction that includes a pool of leased aircraft and intermediary trusts to finance the acquisition of bank debt from the original creditors in the lease. Airlines need to evaluate whether they are the primary beneficiary of the trusts contained in EETC financings. Airlines should also evaluate whether these arrangements are subject to the sale-leaseback provisions of FASB ASC 840-40.

Airport Fuel Facilities

6.97 Airlines participate in numerous fuel consortiums with other airlines at major airports to reduce the costs of fuel distribution and storage. Some of these arrangements are governed by interline agreements that specify the rights and responsibilities of the consortium members and provide for the allocation of the overall costs to operate the consortium based on usage, whereas other fuel consortiums may be structured as limited liability partnerships or corporations. The consortiums (and in limited cases, the participating airlines) enter into long-term agreements to lease certain airport fuel storage and distribution facilities that are typically financed through tax-exempt bonds (either special facilities lease revenue bonds or general airport revenue bonds) issued by various local municipalities. In general, the consortium lease agreement requires the consortium to make lease payments in amounts sufficient to pay the principal and interest payments on the bonds. Exposure to the principal amount of such bonds can be assessed based on the airline's past consortium participation and will be triggered only if the other participating airlines or consortium members default on their lease payments. Consortiums that are governed by interline agreements are not VIEs because they are not legal entities but rather are based on a contractual relationship.

Inherent Risk Factors

6.98 Factors that influence inherent risk related to VIEs might include the following:

- Complex nature of these transactions
- Volume of lease transactions
- Adequacy of available information regarding VIEs

Airport Financings

6.99 Airlines use special purpose revenue bond financings to construct major airport facilities. These bonds are issued by municipalities, government or airport authorities, or finance vehicles of these entities. The financings are typically guaranteed by the airline and are repaid from the lease payments made by the airline under long-term operating leases with the respective government or airport authority. Under these lease agreements, the airline is required to make rental payments in amounts sufficient to pay the principal and interest payments on the bonds. It should be noted that these lease agreements contain terms that are more typical for debt agreements (that is, bullet maturity of principal, put provision for the debt at periodic intervals, or both) because they are structured so that the lease terms match the underlying debt terms. These arrangements are accounted for in accordance with the guidance in paragraphs 2–16 of FASB ASC 840-40-55, paragraphs 2 and 5 of FASB ASC 840-40-15, and FASB ASC 840-10-25-25. Typically, in the construction of a new asset (for example, airport terminal financed with special facility revenue bonds), the airline serves as the construction manager in order to control the quality of the project or retain economic benefits. The airline also generally guarantees the construction period debt (special facility revenue bonds). If the airline is determined to have substantially all construction period risks, the asset and offsetting obligation are recognized on the airline's balance sheet during the construction period. Once construction is complete and the lease begins, the airline needs to evaluate the sale-leaseback transaction under FASB ASC 840-40. Generally, an airline will not be able to qualify for sale-leaseback treatment based on the criteria set forth in FASB ASC 840-40 due to continuing involvement as defined in that guidance. As a result, the asset and offsetting obligation will remain on the airline's balance sheet after the construction is completed. FASB ASC 840-40-25-11 states that a sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback should be accounted for by the deposit method or as a financing, whichever is appropriate under FASB ASC 360-20.

Inherent Risk Factors

6.100 Factors that influence inherent risk related to airport financings might include the following:

- Complexity of airport financing
- Complexity of the accounting literature

Fuel Hedging

6.101 Because hedging is governed by very complex accounting literature, and because this section is intended merely to provide background information to help readers understand how hedging is used in the airline industry, readers should refer to FASB ASC 815, *Derivatives and Hedging*, when considering whether the measurement and disclosure of an entity's derivatives are in conformity with U.S. GAAP.

6.102 Fuel is a significant component of an airline's operating costs, and the price of jet fuel can be extremely volatile. Because airlines' operating results are affected significantly by the price of jet fuel, airlines may develop active jet fuel hedging programs to reduce their exposure to the volatility of jet fuel prices. Airlines typically use a combination of crude oil or heating oil derivatives to hedge their exposure. As an alternative to market-trading derivative contracts, airlines enter into fixed price jet fuel purchase contracts with suppliers, which allow them to purchase jet fuel at fixed prices. Airlines need to evaluate these nonmarket trading contracts to determine whether they should be accounted for as derivatives or whether they meet the normal purchases and normal sales exemption under paragraphs 15–26 of FASB ASC 815-10-15.

6.103 The airline will generally designate the derivative contract as a cash flow hedge of probable forecasted jet fuel deliveries. At hedge inception, the airline needs to prepare contemporaneous written documentation of the hedge relationship containing, among other things, the following information:

- Specific identification of the hedging instrument (for example, crude oil or heating oil contracts)
- A description of the hedge transaction specifying the quantity and timing of the barrels to be purchased (for example, first 100,000 barrels in June)

- The nature of the risk being hedged, for example, changes in cash flows of the collar exposure beyond the strike prices are expected to offset the changes in cash flows of jet fuel purchases
- A discussion of how hedge effectiveness will be determined at hedge inception and on an ongoing basis for a period no longer than each quarter
- A discussion of how the airline will assess hedge effectiveness on a retrospective and prospective basis for a period no longer than each quarter
- A discussion of how the airline will measure hedge ineffectiveness

6.104 Because the jet fuel and the hedging derivative underlying are different commodities, the airline has basis risk due to location differences between the purchase location and derivative location, transportation costs, and refining costs. The airline must assess effectiveness consistent with its hedging documentation whenever financial statements or earnings are reported, and at least every three months. Accordingly, the airline would need to determine if the hedging derivative contract is "highly effective" in offsetting changes in the forecasted jet fuel purchases. Airlines typically use regression models to determine the correlation of the percentage change in price of the derivatives used to hedge jet fuel to the percentage change in price of jet fuel.

Inherent Risk Factors

6.105 Factors that influence inherent risk related to fuel hedging might include the following:

- Authorization of transactions
- Adequate diversification of counterparties
- Timeliness of documentation
- Inclusion of appropriate factors in assessing effectiveness (for example, crack spread and location)
- Assumptions used for determining hypothetical values
- Complexity of financial instruments used and the valuation

Insurance

Captive Insurance

6.106 Larger airlines may have captive insurance companies within their economic family of subsidiaries, either offshore in common locations like Bermuda and Grand Cayman or "onshore" (for U.S. companies) in locations like Vermont and Hawaii. Captive insurers are regulated by state or country insurance regulatory bodies, which also require audited financial statements.

6.107 Airlines may use captive insurers to fund or retain deductible risks or to access certain reinsurance companies interested in insuring aviation risks that for licensing, tax, or regulatory reasons cannot insure an airline directly within the policy syndicate. The captive insurers that are controlled by airlines are consolidated.

Insurer Insolvency

6.108 In case of an accident or incident, the airline would record a loss regardless of whether it has insurance. If an insured loss occurs, and if it is probable that the policy will provide reimbursement for the loss and the amount of the reimbursement can be reasonably estimated, the airline would record a receivable from the insurance enterprise and a recovery of the incurred loss in the statement of operations. In situations in which the airline believes it will have to resort to legal action against the insurer to collect the reimbursement, FinREC believes it would be inappropriate to record a receivable. It is important to note that, in some circumstances, losses and costs might be recognized in the statement of operations in a different (earlier) period than the related recovery.

6.109 Insurance company insolvency can be a significant issue for airlines. Aviation insurance is occurrence-based coverage, and accidents or incidents in the current year may take a number of years to completely pay out. During this period, an insurance company's financial condition can change significantly. Therefore, an insurer from past insurance programs could result in an uncollectible insurance payment today, causing the insured (airline) to reassume the financial responsibility. The unusual syndicated structure of aviation insurance further increases the airlines' chances of having insolvent insurers in their current and past insurance policies.

6.110 Most airlines manage this risk when they purchase insurance by following financial security guidelines in the selection of insurers for their syndicates (S&P, Best's Insurance Rating, Fitch, and so forth). Also, risk management departments and insurance brokers monitor significant changes in financial ratings for current insurers and usually provide an annual review of significant changes in financial condition of past insurers to monitor insolvency risk.

6.111 Aviation insurance plays a major role in aircraft financing and debt arrangements, providing security in the event of loss affecting a secured interest, and providing additional protection for financing groups, which may be named in airline operations-related lawsuits. To that end, many airlines have insurance-related contractual requirements affecting their ability to self-insure certain risks, deductibles they can carry, the financial quality of insurers they insure with, kinds and amounts of insurance they need to carry, and other restrictions. The consequences of breaching these contractual covenants, including their "cure" provisions, can be significant and may need to be disclosed.

Inherent Risk Factors

6.112 Factors that influence inherent risk related to insurance might include the following:

- Ability to obtain insurance and adequate coverage levels
- Consolidation issues for captive insurers
- Insurer insolvency risk

Chapter 7

Financial Reporting and Disclosures

Introduction

7.01 This chapter discusses financial statement presentation and disclosure considerations as they relate to the airline industry. Airline industry disclosure topics are also included in other chapters of this guide. Disclosure topics covered in this chapter are those that are either significant or unique to the airline industry or are unique in an airline-specific application. The discussion in this chapter does not include other financial statement disclosures required by U.S generally accepted accounting principles (GAAP) that are not significant or unique to the airline industry. For those nonairline-specific disclosures, readers may wish to refer to the AICPA publication *Checklists and Illustrative Financial Statements for Corporations*, which includes disclosures that should be considered by commercial corporations in preparing financial statements in conformity with U.S. GAAP. Practitioners may also find it helpful to review financial statements and related disclosures of specific airlines, most of which can be found on the Securities and Exchange Commission (SEC) website at www.sec.gov.

7.02 The disclosures discussed in this chapter that are identified with **(SEC)*** are applicable to entities subject to SEC reporting requirements that prepare their financial statements in conformity with U.S. GAAP pursuant to the SEC's reporting requirements. Items that are identified with an asterisk are *not* required to be disclosed by non-SEC reporting airlines.

7.03 A *public entity*, as the term is used in this chapter, is a business entity that has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), that is required to file financial statements with the SEC or that provides financial statements for the purpose of issuing any class of securities in a public market.[1]

7.04 All other disclosures discussed in this chapter are applicable to all airlines (both SEC-reporting and non-SEC reporting). Some of those disclosures are required by authoritative literature and, therefore, should be included in financial statements prepared in conformity with U.S. GAAP, if applicable. This chapter also discusses a number of disclosure items that are not explicitly required by authoritative literature. The AICPA Financial Reporting Executive Committee (FinREC) believes, however, that such disclosures are good industry practice and, therefore, recommends that airlines include them in their financial statements, if applicable. To distinguish such recommended disclosure items from the ones that are required, recommended disclosures are clearly identified in this chapter as being *encouraged* or *recommended*.

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[1] This definition is consistent with the definition provided in the Financial Accounting Standards Board *Accounting Standards Codification* glossary.

Accounting Policies and Disclosures

7.05 As required by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 235-10-50-3, disclosure of accounting policies should identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following: (*a*) a selection from existing alternatives; (*b*) principles and methods peculiar to the airline industry even if such principles and methods are predominantly followed by the airline industry; or (*c*) unusual or innovative applications of GAAP.

7.06 Following are the areas typically considered in the selection and application of accounting policies related to airlines. Disclosures related to accounting policies that are required or recommended for airlines are also identified.

Passenger and Other Revenue Recognition

7.07 A detailed discussion of the passenger revenue recognition processes and the related accounting issues for passenger ticket activities and other service activities is included in chapter 3, "Marketing, Selling, and Providing Transportation," of this guide.

7.08 Pursuant to FASB ASC 235-10-50-3, an airline should disclose its accounting policy for the recognition of revenue. FASB ASC 235-10-50-3 states that the disclosure encompass important judgments as to appropriateness of principles relating to recognition of revenue.

7.09 Passenger and other revenue recognition involves the use of judgments and estimates, which may have a significant effect on the airline's results. FinREC believes the disclosure of significant accounting policies should include sufficient detail to allow users of the financial statements to understand the revenue recognition policies, including the timing of when revenue is recognized, and FinREC recommends that the disclosure include the methods used by management to develop estimates.

7.10 Unused tickets represent the main component of air traffic liability, and certain unused tickets are recognized in revenue using estimates. Significant changes in business conditions, passenger behavior, or both, that affect these estimates could have a material effect on the financial statements. Accordingly, airlines should make any disclosures required by FASB ASC 275-10-50-1, specifically the nature of operations, use of estimates in the preparation of the financial statements, certain significant estimates, and current vulnerability due to certain concentrations. In addition, FinREC recommends that airlines' policy disclosures for unused tickets discuss revenue breakage and highlight the use of estimates, historical experience factors, expiration dates, or other relevant data regarding ticket terms and conditions.

7.11 For public entities, SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*, provides that "because revenue recognition generally involves some level of judgment, the staff believes that a registrant should always disclose its revenue recognition policy. If a company has different policies for different types of revenue transactions, including barter sales, the policy for each material type of transaction should be disclosed." An airline's major source of revenue relates to the sale of passenger tickets. Other sources of revenue may include the sale of miles to frequent flyer program (FFP) participants (see "Frequent Flyer Programs" in this chapter for further discussion), code sharing agreements with other airlines, and other fees such as change fees. If revenue related to code sharing arrangements is material, an airline is encouraged to include a description of where the revenue and the associated costs are presented in the statement of operations. **(SEC)***

Cargo Carriers Revenue Recognition

7.12 A detailed discussion of the cargo revenue recognition processes and the related accounting issues for air cargo activities is included in chapter 8, "Air Cargo Operations," of this guide. As indicated in "Passenger and Other Revenue Recognition" in this chapter, SAB No. 104 requires that public entities disclose their method of revenue recognition related to each major type of revenue-generating activity, which for cargo carriers typically includes package delivery, freight services, and logistics contracts. **(SEC)***

7.13 As discussed in FASB ASC 605-20-25-13, cargo carriers are currently using a variety of methods of revenue and expense recognition for in-transit shipments. However, it is not acceptable for cargo carriers to recognize revenue when freight is received from the shipper or when freight leaves the carrier's terminal with expenses recognized as incurred. Consistent with the requirements of FASB ASC 235-10-50-3, cargo carriers should disclose the method applied, including the nature and significance of the estimation process and the accounting policies regarding adjustments to revenue and accounts receivable relating to items such as money-back service guarantees and billing corrections, if material. Airlines should also make any disclosures required by FASB ASC 275-10-50-1.

7.14 Transportation services may be provided by independent contractors. If material, consistent with the requirements of FASB ASC 235-10-50-3, an airline should disclose the method of revenue recognition related to logistics contracts where the entity is considered either the principal (gross presentation) or the agent (net presentation) as discussed in FASB ASC 605-45-45-1. FinREC also recommends disclosing components of revenue recorded on a net basis.

Frequent Flyer Programs

7.15 A detailed discussion of FFPs and the related accounting issues is included in chapter 3 of this guide. The policies and estimation methods used to recognize service to be provided under FFPs have a significant effect on the measurement and recognition of revenue and costs related to those programs. Because there are two methods of accounting for FFPs, consistent with the requirements of FASB ASC 235-10-50-3, airlines should disclose the method adopted—that is, the incremental cost method or the deferred revenue method—as well as any material policy choices made in applying the method selected. For example, airlines using the incremental cost method would disclose their method of determining which frequent flyer awards a liability is recognized for and a description of the principal costs that are included in the determination of incremental cost, whereas airlines using the deferred revenue method would disclose their method of calculating the amount of revenue that is deferred and the method of subsequently recognizing that deferred revenue into revenue. Airlines should also disclose material changes in estimates related to FFPs in accordance with FASB ASC 250-10-45-17. In addition, FinREC recommends that airlines include the following disclosures in their financial statements in relation to FFPs:

- A description of the terms of the FFP
- The method of accounting for awards to be provided by other airlines and nonair travel awards
- For revenue from sales of frequent flyer miles or points, the classification of the marketing and travel components
- Disclosures related to the prepurchase of miles by a third party

*FFP Related Disclosures for Public Airlines (SEC)**

7.16 Public airlines generally provide expanded disclosures in their SEC filings concerning their frequent flyer travel award programs. These disclosures are typically shown in the "Description of the Business" section of the airline's SEC filings, although they may be included in the financial statements or in the "Management's Discussion and Analysis" (MD&A) section. Material changes in interim periods should be disclosed in quarterly reports on Form 10-Q. Common industry practice for public airlines is to disclose the following:

- The significant terms of any frequent flyer and other free travel award programs sponsored by the airline.
- The method of accounting for any frequent flyer and other free travel award 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 or 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 other similar measure). If the number of the 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.

7.17 In addition, in accordance with SAB No. 104, for sales transactions that have multiple units of accounting (such as sales of frequent flyer miles or points), public airlines should state clearly in their accounting policy disclosures the accounting policy for each unit of accounting as well as how the units of accounting are determined and valued. **(SEC)***

Credit Card Holdbacks

7.18 Chapter 3 of this guide provides a discussion of the accounting for credit card holdbacks. If these amounts are material, airlines are encouraged to disclose the nature and terms of the arrangements, the balance of the holdbacks, and where the holdbacks are presented in the statement of financial position. Consistent with FASB ASC 275-10-50-1, airlines should also consider disclosing conditions or covenants within these agreements that could materially affect the amount of the holdback.

Aircraft Acquisition Costs

7.19 Fixed assets and related accounting issues are discussed in chapter 4, "Acquiring and Maintaining Property and Equipment," of this guide. If costs associated with the acquisition of aircraft and aircraft-related costs are material to an airline's financial statements, the airline should disclose its policies for accounting for such costs in accordance with FASB ASC 235-10-50-3.

Spare Parts

7.20 Spare parts and related accounting issues are discussed in chapter 4 of this guide. If spare parts are material to the airline's financial statements, consistent with the requirements of FASB ASC 235-10-50-3, the airline should disclose its accounting policy, including the method used to value its spare parts and supplies and the method used to establish an allowance for obsolescence, including residual value assumptions.

Maintenance and Repair Costs

7.21 The acceptable methods of accounting for maintenance and repair costs are described in chapter 4 of this guide. Per FASB ASC 360-10-25-5, the use of the accrue-in-advance (accrual) method of accounting for planned major maintenance activities is prohibited in annual and interim financial reporting periods. FASB ASC 908-360-25-2 provides three accounting methods for overhaul expenses which may be used, specifically, the direct expensing method, the built-in overhaul method or the deferral method. Although different methods may be used for different aircraft, as well as airframe and engine overhauls, FASB ASC 360-10-45-1 requires the same method be used for interim and annual financial statements. Consistent with the requirements of FASB ASC 235-10-50-3, the airline should disclose its method of accounting for planned major maintenance activities.

7.22 If the airline has contracted for maintenance on a basis other than for services as rendered (for example, power-by-the-hour contracts), disclosures are encouraged in sufficient detail to identify the method of determining payments under the contract, how the maintenance costs are recognized, and whether there are contingencies in the contract.

7.23 If an airline has lease agreements that require deposits or supplemental rent to be paid to the lessor that are to be used to reimburse the airline or third-party providers for maintenance of leased aircraft, the airline is encouraged to disclose how those payments are accounted for and where the related expense is classified in the statement of operations. If the airline accounts for maintenance deposits as assets as described in FASB ASC 840-10-05-9B and in chapter 4 of this guide, FinREC believes the airline also should consider disclosing the balance of the deposit account as of the balance sheet date. In addition, for maintenance deposits that are refunded only if the lessee performs specified maintenance activities (which, as provided in FASB ASC 840-10-35-9A, would be expensed when an amount on deposit is less than probable of being returned to reimburse the costs of the maintenance activities incurred by the lessee), the airline is encouraged to disclose its policy for evaluating the probability of those deposits being used to fund maintenance.

Leases

7.24 A detailed discussion of leases and related accounting issues is included in chapter 4 of this guide. FASB ASC 840-10-50-2 provides the required disclosures for leases in the financial statements of a lessee.

*Lease Disclosure Considerations for Public Entities (SEC)**

7.25 In a 2005 letter to the AICPA, the chief accountant of the SEC emphasized that registrants should ensure that the disclosures regarding both operating and capital leases clearly and concisely address the material terms of and accounting for leases. In the airline industry, this might also include costs associated with lease return conditions that are accounted for as contingent rentals and airport leasehold improvements that are amortized over a period that is longer than the contractually stated lease term. These disclosures should provide basic descriptive information about material leases, unusual contract terms, and specific provisions in leases relating to rent increases, rent holidays, contingent rents, and leasehold incentives. The accounting for leases should be clearly described in the notes to the financial statements and in the discussion of critical accounting policies in MD&A, if appropriate. Known likely trends or uncertainties in future rent or amortization expense that could materially affect future operating results or cash flows should be addressed in MD&A. The disclosures should address the following:

- Material lease agreements or arrangements
- The essential provisions of material leases, including the original term, renewal periods, reasonably assured rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives, and unusual provisions or conditions
- The accounting policies for leases, including the treatment of each of the previously listed components of lease agreements
- The basis on which contingent rental payments are determined with specificity, not generality

- The amortization period of material leasehold improvements made either at the inception of the lease or during the lease term, and how the amortization period relates to the initial lease term

Asset Impairment

7.26 Issues related to the impairment of long-lived assets are discussed in chapter 4 of this guide. Under FASB ASC 360-10-35-21, airlines are required to perform an impairment test whenever events or changes in circumstances indicate that the asset's carrying amount may not be recoverable.

7.27 Events or circumstances leading to an impairment of long-lived assets may include grounding or acceleration of aircraft retirement dates, regulatory changes, terrorist activities, significant negative industry or economic trends, significant changes in the use of the assets, or reduced passenger traffic and yields. FinREC recommends that an airline's policy for the evaluation of the carrying amounts of long-lived assets be disclosed in the notes to the financial statements, including a description of how the airline measures an impairment loss.

7.28 FASB ASC 360-10-50-2 sets forth disclosure requirements for impairment losses on long-lived assets to be held and used. If an impairment loss related to long-lived assets classified as "held for use" is included in the financial statements, the airline's disclosures shall include (*a*) a description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment; (*b*) if not separately presented on the face of the statement, the amount of the impairment loss and the caption in the statement of operations that includes that loss; (*c*) the method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique); (*d*) if applicable, the segment in which the impaired long-lived asset (asset group) is reported under FASB ASC 280, *Segment Reporting*.

7.29 FinREC encourages airlines to consider also disclosing the following matters:

- Future plans for the impaired assets
- The method for determining the lowest level at which assets are tested for impairment
- Management's policies for the review of the estimated useful lives and salvage values for aircraft and spare parts
- Significant assumptions used by management to estimate the fair value of the assets and the future cash flows, including discount rate, asset utilization, service life of the asset, and estimated salvage value
- Significant factors that indicated assets may be impaired and influenced the timing of loss recognition
- Anticipated fleet retirement or replacement schedules and pending aircraft orders

Restructuring and Special Charges

7.30 Due to a variety of economic and competitive factors, airlines may decide to reduce operations, exit certain markets, retire a fleet of aircraft, or otherwise exit operating activities or dispose of long-lived assets. FASB ASC

420-10 sets forth reporting and disclosure requirements for exit and disposal activities.

7.31 SAB No. 100, *Restructuring and Impairment Charges*, provides guidance regarding the extent of disclosures that should be included in MD&A related to restructuring and special charges. The SEC staff believes that it is necessary for a public entity to present material exit and involuntary termination charges in tabular form, with the related liability balances and activity (for example, beginning balance, new charges, cash payments, other adjustments with explanations, and ending balances) from balance sheet date to balance sheet date to explain fully the components and effects of significant restructuring charges. The SEC staff also stated its belief that MD&A should include discussion of the events and decisions that gave rise to the exit costs and exit plan, and the likely effects of management's plans on financial position, future operating results, and liquidity unless it is determined that a material effect is not reasonably likely to occur. This discussion should include whether the cost savings are expected to be offset by anticipated increases in other expenses or reduced revenues and clearly identify the income statement line items to be affected. Registrants should identify the periods in which material cash outlays are anticipated and the expected source of their funding. Registrants should also discuss material revisions to exit plans, exit costs, or the timing of the plan's execution, including the nature and reasons for the revisions. For exit costs and involuntary employee termination benefits relating to multiple exit plans, presentation of separate information for each individual exit plan that has a material effect on the balance sheet, results of operations, or cash flows generally is appropriate. A detailed discussion of issues related to labor relations, including severance benefits, is included in chapter 5, "Employee-Related Costs," of this guide. **(SEC)***

7.32 The SEC staff also has noted that the economic or other events that cause a registrant to consider or adopt an exit plan, or both, or that impair the carrying amount of assets generally occur over time. Accordingly, the SEC staff believes that, as those events and the resulting trends and uncertainties evolve, they often will meet the requirement for disclosure pursuant to the MD&A rules prior to the period in which the exit costs and liabilities are recorded pursuant to GAAP. Additionally, whether or not currently recognizable in the financial statements, material exit or involuntary termination costs that affect a known trend, demand, commitment, event, or uncertainty to management, should be disclosed in MD&A (for example, employee termination costs when the number of personnel to be terminated has been identified but the job classifications or functions and locations have not). **(SEC)***

7.33 In periods subsequent to the initiation date, material changes and activity in the liability balances of each significant type of exit cost and involuntary employee termination benefits (either as a result of expenditures or changes in or reversals of estimates of the fair value of the liability) should be disclosed in the notes to the interim and annual financial statements and discussed in MD&A. Additionally, if actual savings anticipated by the exit plan are not achieved as expected or are achieved in periods other than as expected, MD&A should discuss that outcome, its reasons, and its likely effects on future operating results and liquidity. See the text of SAB No. 100 for details of the required disclosures. **(SEC)***

7.34 With respect to "special charges," the SEC staff has indicated its expectation that, to the extent that an airline takes a "special" charge not otherwise qualifying as a restructuring charge, disclosures similar to those accompanying a restructuring charge should be provided. **(SEC)***

Financing Arrangements

Variable Interest Entities

7.35 Airlines may have arrangements that need to be evaluated under FASB ASC 810-10-15. Examples include capacity purchase agreements with regional carriers; aircraft leases that contain residual value guarantees or fixed price purchase options; financings using enhanced equipment trust certificates, and airport fuel facility consortiums. Common structures and the related accounting issues are discussed in chapter 6, "Other Accounting Considerations," of this guide. Paragraphs 3–4 of FASB ASC 810-10-50 set forth disclosure requirements for airlines that have a variable interest in a variable interest entity.

Derivative Instruments and Hedging Activities

7.36 Airlines enter into a wide variety of derivative instrument transactions to manage varying risks, including fuel price risk, interest rate risk, and foreign currency exchange rate risk. Chapter 6 of this guide discusses fuel hedging and related accounting issues.

7.37 FASB ASC 815-10-50 sets forth disclosure requirements for derivative instruments. Under FASB ASC 815-10-50-1, an airline with derivative instruments is required to disclose information to enable users of the financial statements to understand (*a*) how and why it uses derivative instruments, (*b*) how derivative instruments and related hedged items are accounted for under FASB ASC 815, *Derivatives and Hedging*, and (*c*) how derivative instruments and related hedged items affect an airline's financial position, financial performance, and cash flows. FASB ASC 815-10-50-4E, states that the quantitative disclosures required by paragraphs 4A(a)–4A(b) of FASB ASC 815-10-50 should be presented in tabular format except for the information required for hedged items by FASB ASC 815-10-50-4C(a). FASB ASC 815 requires disclosure of derivative features that are credit risk related to provide more information about an entity's liquidity. In order to enable financial statement users to locate important information about derivative instruments, FASB ASC 815-10-50-4I requires cross-referencing from the derivative instruments footnote to the other footnotes in which derivative-instrument-related information is disclosed.

7.38 In accordance with FASB ASC 815-10-50-1A, an airline that uses derivative instruments should disclose for every annual and interim reporting period for which a statement of financial position and a statement of financial performance are presented, its objectives for holding or issuing those instruments, the context needed to understand those objectives, its strategies for achieving those objectives, and information that would enable users of its financial statements to understand the volume of its activity in those instruments.

7.39 FASB ASC 815-10-50-1B states that information about those instruments should be disclosed in the context of each instrument's primary underlying risk exposure (for example, interest rate, credit, foreign exchange rate, interest rate and foreign exchange rate, or overall price). Further, those instruments should be distinguished between those used for risk management purposes and those used for other purposes. Derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 58 and 66 of FASB ASC 815-20-25) used for risk management purposes include those designated as hedging instruments under FASB ASC 815-20, as well as those used as economic hedges and for other purposes related to the entity's risk exposures.

7.40 For derivative instruments designated as hedging instruments under FASB ASC 815-10-50-2, the description should distinguish between derivative instruments (and non derivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, and derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure in a net investment in a foreign operation and derivative investments used as economic hedges and for other purposes related to the entity's risk exposures, and derivative instruments used for other purposes. Per FASB ASC 815-10-50-4, for derivative instruments not designated as hedging instruments under FASB ASC 815-20, the description should indicate the purpose of the derivative activity.

7.41 An airline should also disclose information that would enable users of its financial statements to understand the volume of its derivative activity. Airlines should select the format and the specifics of disclosures relating to their volume of derivative activity that are most relevant and practicable for their individual facts and circumstances.

7.42 Airlines are encouraged to discuss their objectives and strategies in the context of their overall risk exposures. Per FASB ASC 815-10-50-5, qualitative disclosures about an entity's objectives and strategies for using derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 58 and 66 of FASB ASC 815-20-25) may be more meaningful if such objectives and strategies are described in the context of an entity's overall risk exposures relating to all of the following: interest rate risk, foreign exchange risk, commodity price risk, credit risk, and equity price risk. Those additional qualitative disclosures, if made, should include a discussion of those exposures even though the entity does not manage some of those exposures by using derivative instruments. Entities are encouraged, but not required, to provide such additional qualitative disclosures about those risks and how are they are managed.

7.43 For SEC registrants, Regulation S-X, Rule 4-08(n), contains financial statement requirements for derivative instruments and hedging activities. **(SEC)***

Commitments and Contingencies

7.44 An airline needs to evaluate its agreements and relationships with third parties to ensure its material contractual obligations and contingent liabilities are adequately disclosed in the notes to the financial statements. Commitments and contingencies typically disclosed by airlines include purchase commitments (including orders for aircraft and fuel purchase commitments), capacity purchase agreements, legal and environmental matters, lease arrangements, general guarantees and indemnifications, collective bargaining agreements (CBAs), and other employee matters. FASB ASC 460-10-50-4 provides guidance on the disclosures to be made by an entity about its obligations under certain guarantees and indemnifications that it has issued.

Capacity Purchase Agreements

7.45 Major airlines typically contract with regional airlines to provide connecting service into the major airline's hub(s). These services are typically provided for under prorate or capacity purchase arrangements. A detailed discussion of prorate and capacity purchase arrangements and the related accounting issues is included in chapter 9, "Regional Airlines," of this guide.

Major Airline Disclosures

7.46 FinREC recommends that the major airlines disclose the following with respect to capacity purchase agreements:

- The nature and terms of the agreement
- Any termination provisions
- Any minimum contractual commitments
- The statement of operations caption that includes the costs associated with a lease contained within a capacity purchase agreement
- A description of any contractual payments made to the regional airline along with a description of the arrangement
- If the major airline has a call option to acquire aircraft from the regional airline, the nature and terms of the arrangement, including conditions under which the option is exercisable

Regional Airline Disclosures

7.47 Because the determination of the appropriate presentation method for revenues and costs under capacity purchase agreements is driven by the nature and terms of the contracts involved (the regional's contract with the major and the contract to obtain the services), the same types of pass-through costs may be presented differently by different carriers. For example, based on different contractual relationships, one regional carrier may net fuel costs whereas another may reflect those costs and the related revenue on a gross basis. With respect to pass-through costs, FinREC recommends that regional airlines consider making the following disclosures in the notes to their financial statements:

- The nature, terms, and amounts (which may require estimations and allocations) of contractual arrangements between the regional and major airline
- Costs that would ordinarily be required to be incurred in the operation of the regional airline consistent with service requirements of the capacity purchase agreement that are not being incurred because they are absorbed by the major airline, such as fuel obtained from the major airline without charge
- Gross transaction volume for revenue reported net, if reasonably determinable in accordance with FASB ASC 605-45-50-1

7.48 Airlines should also make any related-party disclosures required under FASB ASC 850-10-50-1.

Air Cargo Capacity Guarantees

7.49 As discussed in chapter 8 of this guide, some air cargo carriers provide aircraft, crew, maintenance, and insurance (ACMI) services to other air cargo carriers. Under these ACMI contracts, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation, which is generally expressed on an annual basis in the contract. FinREC recommends that cargo carriers consider including the following disclosures in the notes to their financial statements:

- A description of the carrier's revenue recognition policies related to ACMI contracts, including discussion of minimum payments and penalties
- A description of typical ACMI contractual terms, as well as any unusual terms related to significant contracts and information regarding the timing and payment of minimum contractual amounts and penalties
- The percentage of revenue generated from ACMI contracts
- A discussion of expenses absorbed by the customer rather than the service provider under the terms of the contracts
- Future contractual minimum revenues expected from ACMI contracts

Segment Disclosures (SEC)*

7.50 FASB ASC 280-10-50 establishes standards for the way that public entities report information about operating segments in annual financial statements. FASB ASC 280-10-50-32 requires that those enterprises report selected information about operating segments in interim financial reports. Paragraphs 40–42 of FASB ASC 280-10-50 provide guidance for related disclosures about products and services, geographic areas, and major customers.

Operating Segments

7.51 An operating segment is defined in FASB ASC 280-10-50-1 as a component of a public entity

a. that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same public entity);

b. whose operating results are regularly reviewed by the public entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and

c. for which discrete financial information is available.

7.52 Paragraphs 11–12 of FASB ASC 280-10-50 provide aggregation criteria and quantitative thresholds for determining which operating segments should be reported separately in the financial statements.

7.53 Airline operations are often managed as a single business unit: air transportation, which includes the common carriage of passengers, freight, and mail over routes authorized by the Department of Transportation (DOT). Accordingly, many airlines disclose only a single reportable segment.

7.54 Some airlines manage their operations on a geographical basis, in which case, each geographical operation might meet the definition of an operating segment. Those operating segments that meet the quantitative thresholds described in FASB ASC 280-10-50-12 should be reported separately unless they meet the aggregation criteria described in FASB ASC 280-10-50-11. Airlines often allocate operating revenues to geographic reportable segments based on the origin and destination of their flight segments. Information necessary to meet certain segment and geographical area disclosure requirements of FASB ASC 280-10-50-41 may, in some instances, be similar to that which airlines report to the DOT on Form 41 (see chapter 10, "Special Reports and Example Reporting," of this guide for discussion of DOT Form 41). Because much of an airline's tangible operating equipment can be deployed across geographic markets, airlines often do not assign long-lived assets to geographical areas. When assets are assigned, certain assets, such as inventory and other ground facilities, may be directly attributable to a reportable segment and, therefore, are identified directly with that segment. Other assets are generally used in more than one segment and can be allocated to the segments by applying ratios similar to those used in the allocation of expenses.

7.55 According to FASB ASC 280-10-50-21, a public entity is required to disclose the factors used to identify the entity's reportable segments, including the basis of organization and the types of products and services from which each reportable segment derives its revenues. The following sections highlight some of the factors that may be considered by the major, regional, and cargo carriers when identifying potential operating segments.

Major Airlines

7.56 If the major airline carrier operates a regional airline, a low-cost airline, or an all-cargo fleet within the larger airline, that operating unit should be evaluated to determine whether it qualifies as a separate operating segment.

Regional Airlines

7.57 If a regional airline has different types of revenue arrangements (for example, prorate and capacity purchase agreements), it needs to determine if the different revenue arrangements constitute separate operating segments. Additionally, a regional carrier may segregate operating revenue and expenses based on agreements with different capacity purchase partners or operating subsidiaries. In certain situations, in order to comply with provisions in their capacity purchase agreements, regional airlines form separate operating subsidiaries organized around Air Carrier Certificates (*operating certificates*) issued by the DOT. These limitations, called *scope restrictions*, are imposed by the CBAs at the mainline carriers and typically specify the size of the aircraft that may be flown under the operating certificate of affiliated carriers. In order for the major airline to comply with these limitations, the regional carrier may be required under the capacity purchase agreement to segregate its aircraft by size, code-share partner, or both, under separate operating certificates. In so doing, the regional airline may also be segregating operating revenue and expenses by reporting subsidiary.

7.58 In the situations previously described, the regional airline may have discrete financial information for each type of revenue arrangement, capacity purchase agreement, or operating subsidiary, and the related discrete operating results may be regularly reviewed by the regional airline's chief operating decision maker to assess performance and make decisions about resource allocation. In those situations, the regional airline would look to criteria set forth in FASB ASC 280-10-50-11 to determine if some or all of these operating segments could be aggregated into a single reportable segment.

Cargo Carriers

7.59 Cargo carriers typically segment their business using functional or geographic criteria or some hybrid thereof. Functionally, an airline might segregate operations that include delivery of cargo from forwarding services and logistics operations. Operations that deliver via aircraft or other express transportation may be segregated from ground delivery. Geographically, a business might segregate domestic operations from international or by a method of regional delineation. Often, an entity may segregate its operations using functional criteria and further segregate using geographic criteria. For example, package operations may be broken into both domestic and international package operations.

All Carriers

7.60 In addition, carriers may have various subsidiaries or other business units that contribute to the operations of the airline. For example, they may have separate subsidiaries or businesses for the repair and maintenance of aircraft, food service, or hotels. These operations need to be evaluated in accordance with FASB ASC 280-10-50 to determine if they should be reported separately.

Pensions and Other Postretirement Benefits

7.61 Obligations and costs related to pensions and other postretirement benefits are significant to many airlines. A detailed discussion of pensions and other postretirement benefits is included in chapter 5 of this guide. For financial statement disclosure requirements for defined benefit plans and other postretirement benefits, readers should refer to FASB ASC 715-20-50.

7.62 Changes in capital markets and interest rates can significantly affect the market value of employee benefit plan assets, as well as the assumptions used in determining the plan obligations, funded status, and expected future employer contributions. An airline should refer to the provisions of FASB ASC 715-20-50-1, regarding required disclosures about certain key assumptions and describing the basis for determining some of them. FASB ASC 715-20-50-1(f) requires disclosure of the benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years and in the aggregate for the five fiscal years thereafter. Additionally, an airline is required under FASB ASC 715-20-50-1(g) to provide its best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining (*a*) contributions required by funding regulations or laws, (*b*) discretionary contributions, and (*c*) noncash contributions.

7.63 According to SEC Financial Reporting Release No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, if activity within an existing plan, such as earnings or returns on invested plan assets, has a material impact on the entity's liquidity, capital resources, or results of operations, that activity should be discussed in MD&A. **(SEC)***

Risks and Uncertainties

7.64 In accordance with FASB ASC 275-10-50-1, entities are required to provide disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas: nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by FASB ASC 275-10 may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other FASB ASC topics. Disclosures in SEC filings regarding risk factors are discussed subsequently in this chapter.

7.65 In accordance with the requirements of FASB ASC 275-10-50, an airline, like entities in other industries, should provide a brief description of the nature of its operations and a statement regarding the use of management's estimates in the preparation of financial statements. Disclosures regarding significant estimates may be made in the context of related disclosures, for example, in disclosures about impairment of assets, valuation of deferred tax assets, litigation-related obligations, and revenue breakage.

7.66 As stated in FASB ASC 275-10-50-16, vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance. Additionally, FASB ASC 275-10-50-16 provides that certain concentrations should be disclosed if all of the following conditions are met: (*a*) the concentration exists at the date of the financial statements, (*b*) the concentration makes the enterprise vulnerable to the risk of near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

7.67 In the airline industry, concentrations arise, for example, in the availability of labor resources or, especially at regional carriers, as a result of capacity purchase agreements.

7.68 FASB ASC 275-10-50-20 provides that, for concentrations of labor subject to CBAs, disclosure should include both the percentage of the labor force covered by a CBA and the percentage of the labor force covered by a CBA that will expire within one year.

7.69 Additionally, FinREC recommends that airlines with a labor force subject to CBAs disclose each employee group covered under a CBA, the amendable dates of the respective contracts, which contracts are open for negotiations, and the airline's accounting policy for expected retroactive wage increases under new or amended contracts. A detailed discussion of issues related to labor relations, including amendable labor contracts, is included in chapter 5 of this guide.

7.70 FinREC encourages regional airlines with capacity purchase agreements to discuss the stability of their major airline partner regardless of whether the disclosure criteria in FASB ASC 275-10-50 are met.

Sales Taxes

7.71 A detailed discussion of the types of taxes and fees relating to the airline industry is included in chapter 3 of this guide.

7.72 Paragraphs 3–4 of FASB ASC 605-45-50 require disclosure of the accounting policy for any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer (that is, gross or net basis). For taxes reported on a gross basis, an airline should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The disclosure of those taxes can be done on an aggregate basis.

Other SEC Disclosures (SEC)*

Risk Factors

7.73 Regulation S-K, Item 503(c), requires disclosure of significant business risk factors in SEC filings. A number of business risks exist in the airline industry, including the following:

- General economic conditions
- Geopolitical risks
- Competition
- Regulation
- International operations
- Service interruptions
- Price and availability of fuel
- Labor costs
- Pension and other postretirement obligations
- Insurance availability and costs
- Security costs and operational constraints
- Significant operating losses
- High levels of debt
- Interest rate changes
- Liquidity and airline bankruptcies
- Potential technology failures
- Safety issues
- Dependence on key personnel
- Reliance on a limited number of suppliers
- Aircraft utilization

7.74 Although this list is not complete, it is recommended that airlines consider these and other risks for disclosure.

Critical Accounting Policies, Judgments, and Estimates

7.75 In a December 12, 2001, release, the SEC encouraged companies to provide in MD&A full explanations, in plain English, of their critical accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. In May 2002, the SEC published a proposed rule (Release No. 33-8098) requiring certain disclosures relating to accounting estimates and initial application of accounting policies. In December 2003, the SEC issued Release No. 33-8350, which is an interpretation providing guidance regarding MD&A disclosures. Included in that interpretation is a section regarding accounting estimates and assumptions that may be material, due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. The release states that companies should consider enhanced discussion and analysis of these critical accounting estimates and assumptions that (*a*) supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and (*b*) provides greater insight into the quality and variability of information regarding financial condition and operating performance. Readers should be alert to any final rules or additional interpretive materials published by the SEC.

7.76 An airline should evaluate its accounting policies and significant estimates to determine which ones should be identified as critical accounting policies, judgments, and estimates. Typically, airlines consider the following in their evaluation:

- Revenue recognition (passenger and cargo)
- Long-lived assets, including impairment
- Maintenance policies
- FFPs
- Employee benefit plans
- Goodwill and intangible assets, including impairment
- Derivative and other financial instruments
- Stock-based compensation
- Others as deemed significant to the reporting entity

Off-Balance Sheet Arrangements

7.77 Regulation S-K, Item 303(a)(4), contains MD&A disclosure requirements for off-balance sheet arrangements. The material facts and circumstances of off-balance-sheet arrangements such as guarantees, certain derivatives, retained interests, and variable interests should be disclosed in a separately captioned section of MD&A. The purpose of this disclosure is to provide investors with a clear understanding of the arrangements and their material effects on financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures, and capital resources. MD&A should also include other information that the entity believes is necessary for an understanding of its off-balance-sheet arrangements and the specified material effects. More specifically, an entity should disclose all of the following:

- The nature and business purpose of the off-balance-sheet arrangements
- The importance of off-balance-sheet arrangements to liquidity, capital resources, market risk support, credit risk support, or other benefits
- The overall magnitude of an entity's off-balance-sheet activities, the specific material impact of the arrangements on an entity, and the circumstances that could cause material contingent obligations or liabilities to come to fruition

- Any known event, demand, commitment, trend, or uncertainty that will, or is reasonably likely to, result in the termination, or material reduction in availability to the entity, of its off-balance-sheet arrangements that provide the entity with material benefits and the course of action that the entity has taken or proposes to take in response to any such circumstances

7.78 The disclosure should cover the most recent fiscal year, but it should also address changes from the previous year. MD&A in quarterly reports should inform investors about material changes in the year-end disclosures.

Tabular Disclosure of Contractual Obligations

7.79 Regulation S-K, Item 303(a)(5), contains a requirement to disclose information related to contractual obligations. Disclosure is required in a tabular format of amounts of payments due under specified contractual obligations. The amounts are to be aggregated by category of contractual obligation for specified time periods. The entity must present the information in a table but can determine where within the MD&A to include the table. The information should be as of the latest fiscal year-end balance sheet date, and the table should include separate disclosure of contractual obligations for long-term debt, capital lease obligations, operating lease obligations, purchase obligations, including orders for aircraft, and, collectively, other long-term liabilities reflected on the entity's balance sheet in accordance with U.S. GAAP. It is recommended that interest on long-term debt is either included in the table or discussed in the notes, if material. The obligations should be disclosed in total for each category, and by period due, grouped by due in less than 1 year, due in 1–3 years, due in 3–5 years, and due in more than 5 years. Entities are not required to include this table in MD&A in quarterly reports. However, entities are expected to disclose material changes outside the ordinary course of business that arise during the interim period. Preparers should use judgment in determining the purchase obligations and other obligations to be included, and it is recommended that they include appropriate disclosure clearly describing items included and items excluded, as well as significant assumptions made in preparing the table. In addition to items previously discussed, airlines may need to include other items, if material, in the table of aggregate contractual obligations such as funding requirements for retirement plans and capacity purchase agreements.

Chapter 8

Air Cargo Operations

Background

General

8.01 The air cargo industry consists of full service air cargo airlines or dedicated fleets, regional operators, and passenger airlines that have air cargo operations (air cargo carriers). Air cargo carriers generate revenue primarily through the transportation of cargo and mail. Companies that act strictly as agents in the facilitation of air cargo shipments (typically referred to as *freight forwarders*) are not included within the scope of this guide. Air cargo may be in the form of palletized freight, individual parcels, or containers of commodities such as mail. The primary classes of service used for air cargo are priority mail (airmail and air parcel post), nonpriority mail (airlift of first class mail on a space-available basis), foreign mail (mail destined to or from foreign countries), air express (priority movement of packages, generally under 50 pounds), and air freight (the airlift of palletized commodities).

Aircraft Crew Maintenance and Insurance Contracts

8.02 Some air cargo carriers provide aircraft, crew, maintenance, and insurance services (ACMI) for other airlines. Under an ACMI contract, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation. ACMI contracts typically require customers to guarantee minimum aircraft utilization levels at fixed hourly rates and may be in effect for periods that can range from one day to up to five years, subject in certain limited cases to early termination provisions. These contracts typically require the ACMI, whereas the customers generally bear all other operating expenses, including the following:

- Fuel and fuel servicing
- Marketing costs associated with obtaining cargo
- Airport cargo handling
- Landing fees
- Ground handling, aircraft push-back, and de-icing services
- Specific cargo and mail insurance

8.03 The customers are also typically responsible under these contracts for utilizing the cargo capacity. As a result, ACMI contracts minimize the load factor, yield, and fuel cost risks traditionally associated with the air cargo business and provide a minimum annual revenue base and predictable profit margins. This model also allows customers to utilize an air cargo carrier's efficiencies to expand their presence in the world's cargo markets without committing to aircraft ownership.

8.04 There are multiple arrangements that are based on the ACMI contract model, including dedicated ACMI, fractional ACMI (or the provision of a portion of the capacity of one or more aircraft), and partial ACMI (or the provision of an aircraft on less than a full-time basis). These arrangements typically require customers to commit to certain utilization levels under seasonal contracts and, in many instances, the revenue and cost structure vary from an ACMI contract because the operations may include arrangements for the provision of fuel and ground handling and flight-related expenses. An advantage of these arrangements is that risks that would otherwise be borne by a single customer, such as contract term, load factor, fuel, and ground handling, are shared among several parties. Under many ACMI contracts, the specific equipment or crew to be used is not part of the arrangement. However, the terms of ACMI contracts need to be evaluated under paragraphs 6–15 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 840-10-15.

Customs Services

8.05 Air cargo carriers may also generate revenue through the facilitation of customs clearance of various kinds of air cargo. As licensed customs clearance brokers, air cargo carriers are engaged by importers to prepare the documentation required for goods entering into specific countries. In this capacity, the air cargo carrier is responsible for coordinating all events and communicating the status of shipments from the time of shipment arrival through customs clearance. The air cargo carrier receives commercial and transportation documentation; reviews it for completeness and accuracy; prepares and files documents necessary to clear customs; obtains customs bonds; assists the importer in obtaining the appropriate commodity classification; and arranges for payment of collect freight charges. In many cases, the air cargo carrier also deposits import duties with the applicable customs service on behalf of the importer. In addition, the air cargo carrier may provide ancillary customs brokerage services to its customers, including placement of surety bonds, duty reduction programs, and duty drawback (recovery of duties paid when imported merchandise is reexported). Some air cargo carriers also provide bonded warehouse services, which enable importers to defer payment of customs duties until the cargo is released from bond in conjunction with their production or distribution schedules.

Other Ancillary Services

8.06 Air cargo carriers may also provide other ancillary services, such as special handling and special services. Examples of special handling include transportation of perishable cargo, live animal transportation, offsize cargo, and transportation of dangerous goods (as governed by the International Air Transport Association). Special services include collection or delivery of shipments at customers' facilities; loading and off-loading; preparing cargo for transport using pallets, nets, and straps; and cargo insurance.

Accounting and Auditing Considerations

8.07 Operationally, nonpassenger airlines have many of the same characteristics of passenger airlines. The principal differences lie in the revenue recognition and measurement area, the accounting for cargo damage claims, and the accounting for the conversion of passenger aircraft to freighter aircraft.

Revenue Recognition and Measurement[1]

8.08 Air cargo carriers' revenue is derived primarily from the carriage of cargo and mail and includes, among other things, revenue related to service options such as priority and express delivery preferences and fuel surcharges. Revenue recognition generally involves consideration of two factors: (*a*) being realized or realizable and (*b*) being earned.[2] Revenue is typically considered earned for air cargo carriers when the air cargo carrier provides the transportation service.

Revenue Recognition for Shipments in Transit at the End of a Reporting Period

8.09 FASB ASC 605-20-25-13 recognizes that a variety of revenue and expense recognition methods are currently being used by freight service entities, such as air cargo carriers. However, per the guidance, it is not acceptable for freight carriers (not limited to motor carriers) to recognize revenue when freight is received from the shipper or when freight leaves the carrier's terminal with expenses recognized as incurred.

Revenue and Expense Recognition for Freight Services in Process (SEC)[3,4]

8.10 FASB ASC 605-20-25-13 states that recognition of revenue when freight is received from the shipper or when freight leaves the carrier's terminal with expenses recognized as incurred is not an acceptable method of recognizing revenue and expense for freight carriers. However, a registrant should not change, as a result of that guidance, to recognition of revenue when freight is received from the shipper or when freight leaves the carrier's terminal with accrual of the estimated direct costs to complete delivery of freight-in-transit as this method would not be appropriate because revenue is recognized in advance of performance and liabilities are recognized before they are incurred.

Air Cargo Billing Revenue Process

8.11 The administrative and accounting aspects of the air cargo operation involve the processing required to route and trace shipments and to perform the accounts receivable and accounts payable functions for the associated shipping charges. Shipments and charges for each shipment are based on airbill information. The shipper or, in the case of an infrequent shipper, the air cargo carrier prepares an airbill when an air shipment is originated.

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[1] On January 4, 2012, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU), *Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification*, to improve and align with International Financial Reporting Standards the financial reporting of revenue from contracts with customers and related costs. The core principle of the draft standard is that an entity should recognize revenue from contracts with customers when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer. The proposed standard would replace most of the guidance in FASB *Accounting Standards Codification* (ASC) 605, *Revenue Recognition*. Readers should be alert for the issuance of the final ASU.

[2] Financial Accounting Standards Board Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83.

[3] See footnote 1.

[4] See paragraph 7.02.

8.12 The air cargo carrier whose airbill is used for initiating and routing the shipment becomes the *issuing airline*; later, when transferring the shipment to another carrier, it becomes the *transferring airline*. The air cargo carrier accepting a transferred shipment becomes the *receiving airline*, and the air cargo carrier that terminates a shipment by delivery to the consignee becomes the *delivering airline*. In full service air cargo operations, all of these functions may be performed by the same carrier.

8.13 The basic air cargo revenue accounting functions consist of airbill pricing and airbill invoicing. Airbill pricing includes establishing rates according to published tariffs, rate extension, and revenue apportionment between air cargo carriers. Airbill invoicing includes direct customer billing and interline settlement. Although standard rates typically are published or well known, air cargo carriers often give customer-specific discounts or volume or time period discounts intended to promote increased capacity during lower volume times. These discounts are recognized as the associated revenue is earned, which may vary depending on the specific terms of the discount arrangement.

8.14 This process is further complicated by rules regarding prepaid and collect shipments. On a prepaid shipment, the paid air cargo carrier is identified on the shipping instructions; therefore, downline air cargo carriers, if any, can bill directly to the paid carrier. However, on a collect shipment, upline air cargo carriers frequently do not know the identity of the collecting air cargo carrier because of shipment reroutings. Therefore, air cargo carriers that participate in a collect shipment perform "snowball" billing. Each air cargo carrier bills the adjacent downline air cargo carrier in the route segment for all transportation services up to the point of transfer to that air cargo carrier, thus, snowballing the bills to the collecting air cargo carrier.

8.15 The issuing airline is responsible for retaining an accounting copy of each airbill, supplying airbill copies to the freight revenue accounting audit sections of participating air cargo carriers, and accepting invoices from delivering airlines for shipments carried on prepaid airbills. The delivering airline must accept invoices for collect shipments from the previous transferring airline and can invoice the issuing airline for actual transportation charges for prepaid shipments. Interline settlements are handled in the same manner as settlements of passenger ticket lifts, which are discussed in chapter 3, "Marketing, Selling, and Providing Transportation."

8.16 Because many air cargo airlines use cycle billings, there may be a time lag between the completion of a shipment and the generation of an invoice. Unprocessed transactions may contain a significant portion of air cargo carriers' total monthly revenue. This revenue is recognized through systematic accrual processes. These processes typically include using actual package or shipment volumes and current trends of average revenue per shipment.

Reporting Revenue Gross Versus Net

8.17 Certain air cargo carriers use subcontractors as part of the transportation process, including agreements for fixed air cargo capacity. Additionally, certain air cargo carriers provide ancillary services such as third party logistics and trade services. Examples include warehouse management, customs clearance transaction processing, and brokerage of transportation services. Also, some air cargo agreements provide for surcharges (for example, fuel surcharges that are intended to mitigate the effect of their higher fuel costs.) At issue is whether the revenue from such items should be reported at the gross amount billed to a customer (as a principal) versus at the net amount earned by the air cargo carrier in the transaction (as an agent). FASB ASC 605-45-45-1 provides optional guidance on whether an entity should consider reporting revenue based on the gross amounts billed to a customer because it has earned revenue from the sale of the goods or services or the net amount retained (that is, the amounts billed to the customer less the amount paid to a supplier or subcontractor unless independently billed and collected by the supplier or subcontractor) because it has earned a commission or fee as an agent. The following indicators need to be considered when determining how to properly report revenue from such transactions.

8.18 Paragraphs 4–14 of FASB ASC 605-45-45 identify eight indicators of gross revenue reporting, as follows:

- The air cargo carrier is the primary obligor in the arrangement.
- The air cargo carrier has general inventory risk—before customer order is placed or upon customer return.
- The air cargo carrier has latitude in establishing price.
- The air cargo carrier changes the product or performs part of the service.
- The air cargo carrier has discretion in supplier selection.
- The air cargo carrier is involved in the determination of product or service specifications.
- The air cargo carrier has physical loss inventory risk—after customer order or during shipping.
- The air cargo carrier has credit risk.

8.19 Paragraphs 15–18 of FASB ASC 605-45-45 identify indicators of net revenue reporting, as follows:

- The entity's supplier (not the air cargo carrier) is the primary obligor in the arrangement.
- The amount earned by air cargo carrier is fixed.
- The supplier (not the air cargo carrier) has credit risks.

8.20 As indicated in paragraphs 4–5 of FASB ASC 605-45-45, the primary obligor and general inventory risk are strong indicators of gross reporting. However, the application of the indicators for gross and net reporting of revenue depends on the relevant facts and circumstances and requires significant judgment. Therefore, these strong indicators are not presumptive, and their absence would not require that revenue be reported net. If the air cargo carrier is clearly the principal to a contract, which is typical in the air cargo industry, revenue from sale of these air cargo services, including fuel or other surcharges, should be reported on a gross basis.

Other Ancillary Services

8.21 Some of the additional services discussed in "Customs Services" and "Other Ancillary Services" in this chapter may qualify as separate deliverables and should be evaluated under paragraphs 3–6 of FASB ASC 605-25-25 to determine whether deliverables represent separate units of accounting.

Capacity Guarantees

8.22 As was mentioned previously in this chapter, some air cargo carriers provide ACMI services to other air cargo carriers. Under these ACMI contracts, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation, which is generally expressed on an annual basis in the contract. In these situations, customers could elect to exercise their contractual options to cancel a limited number of guaranteed hours. As a result, an air cargo carrier's revenue might decline as contractual aircraft utilization levels temporarily decrease. Customers typically exercise such cancellation options early in the first quarter of the year, when the demand for air cargo capacity has historically been low, or following the seasonal holiday peak in the latter part of the fourth quarter.

8.23 ACMI contracts usually require customers to pay penalties for failure to meet minimum capacity guarantees. Such penalties are similar to contingent rental income and would be accounted for in a similar manner. FASB ASC 840-10-25-4 and Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition*, provide that contingent rental income becomes accruable when the changes in the factors on which the contingent payments are based actually occur. If penalties are payable at the end of a contractual period, revenue related to penalties may be recognized only at the time when the customer actually fails to meet minimum capacity guarantees, not when it is probable that the customer will fail to meet minimum capacity guarantees.

Revenue Adjustments

8.24 In addition to provisions for credit losses on uncollectible accounts, air cargo carriers often have to make adjustments to revenue and accounts receivable for certain discounts, service guarantees, and billing corrections (which could result from pricing or rating issues). Also, certain air cargo carriers have programs whereby customers receive pricing adjustments if shipment service terms are not fully met. These adjustments are accounted for as a reduction of revenue at the time the revenue is recognized, typically based on historical payment experience.

Inherent Risk Factors

8.25 Factors that influence inherent risk related to cargo carriers' revenue and accounts receivable might include the following:

- The complexity of billing terms and conditions, including the extent of assessorial billings and surcharges
- The number and roles of multiple air cargo carriers involved in determining the total cost of the shipment, the revenue sharing, and gross versus net reporting of revenue
- The sophistication and reliability of systems and processes to capture data about shipments that is pertinent to revenue recognition
- The quality, timeliness, and relevance of data concerning historical credit losses, service failures, and billing corrections
- The period from the point of pick-up to delivery for the air cargo carrier

Cargo Claims Accruals

8.26 According to the Warsaw Convention, air cargo carriers have limited liability for damage sustained to cargo while in transit. Typically, air cargo carriers are liable in the event of loss or damage to cargo. Some air cargo carriers purchase insurance to cover any such damages, whereas other air cargo carriers are self-insured.

8.27 Air cargo carriers that are self-insured need to consider historical loss experience as well as present and expected levels of cost per claim when estimating this liability. The liability for cargo claims needs to take into account an estimate of incurred-but-not-reported claims and the potential salvage value of any damaged shipments retained by the air cargo carrier.

Inherent Risk Factors

8.28 Factors that influence inherent risk related to the measurement of self-insurance obligations might include the following:

- The timeliness and accuracy of information about claims incidence and the effect that current trends may have on the data
- The periods involved in settling outstanding claims
- The amount of recovery, if any, on the subsequent sale of damaged cargo retained by the air cargo carrier

Passenger-to-Freighter Aircraft Conversions

8.29 Air cargo carriers often purchase passenger aircraft that are then converted to freighter aircraft. Passenger-to-freighter conversion involves primarily the removal of the passenger furnishings and installation of a main deck cargo door and cargo handling system. The conversion can be done by the manufacturer, the air cargo carrier, or another party.

8.30 The AICPA Financial Reporting Standards Executive Committee believes that initial costs associated with the conversion, including heavy airframe and other costs necessary to get the aircraft ready for its intended use as a cargo freighter, should be capitalized. See chapter 4, "Acquiring and Maintaining Property and Equipment," for additional discussion regarding costs incurred prior to used aircraft being placed into service.

8.31 Interest on funds used to finance the acquisition or modification of aircraft up to the date that the aircraft is ready for its intended use should be capitalized and included in the cost of the aircraft. See "Advanced Delivery Deposits and Capitalized Interest" in chapter 4 for more information. Depreciation of the costs incurred to modify airframes begins when the aircraft is placed into service and continues until the asset is permanently removed from service.

8.32 Rental costs on aircraft under operating lease should be expensed on a straight-line basis over the lease term. Based on guidance in paragraphs 10–11 of FASB ASC 840-20-25, the lease term begins when the air cargo carrier takes possession of or is given control of the leased aircraft. Accordingly, when the passenger-to-freighter conversion occurs during the lease term, rental costs of the leased aircraft should be expensed and not capitalized as part of the leasehold improvements.

Inherent Risk Factors

8.33 Factors that influence inherent risk related to passenger-to-freighter aircraft conversions might include the following:

- The evaluation of whether a modification affects the useful life of the aircraft or represents routine maintenance on aircraft in service
- The applicable rate for interest capitalization
- The evaluation of the useful life and salvage value of a converted aircraft

Chapter 9

Regional Airlines[1]

Introduction

History of Regional Airlines

9.01 Regional airlines were established in the 1980s for the purpose of providing air transportation to cities that were not capable of supporting major airline jet service. Regional airlines used smaller aircraft and provided connecting traffic from these cities into the hub cities of the major carriers. The major carrier and the regional carrier would create a joint marketing agreement whereby the airlines would coordinate their flight schedules to facilitate the interchange of passengers. Under these agreements, the major airline would allow the regional airline to use the major's reservation system and flight designator code to identify flights and fares in computer reservation systems; permit the regional carrier to use the major airline's paint scheme, logos, service marks, and uniforms; and provide for joint promotion and advertising. These agreements became known as *code-share agreements*. The advantage to both airlines was that each fed passengers to the other. At the inception of these agreements, regional airlines typically flew turboprop aircraft to connecting cities, usually within 250–500 miles of the major airline's hub city. However, in the late 1990s, with the advent of regional jets (generally defined as jet aircraft with fewer than 100 seats), the mission of the regional airlines began to evolve to include not only carrying connecting traffic into and out of hub cities, but also serving longer range connecting routes and certain other long, thinly traveled routes that traditionally had been operated by the major airlines with larger jet aircraft. The significant expansion in the operation of regional airlines in the 1990s occurred primarily as a result of their cost structure, which was lower than that of most of the major airlines due primarily to lower labor costs, thus providing an economical means of growing the major airline's route network with lower operating costs.

Effect of Collective Bargaining on Regional Airlines

9.02 The existence of collective bargaining agreements at major airlines contributed to the growth of independent regional airlines. Regional airlines can be profitable and are beneficial to the major airline only as long as their costs are lower than the major airline's costs. This profitability can be jeopardized if the wage scale at the major airline is implemented at the regional airline. Wage structures at wholly owned regional airlines are often affected when the collective bargaining agreement at the major airline opens for negotiation. Typical collective bargaining agreements provide a wage scale in which

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[1] This chapter contains numerous references to fair value. This guide has been updated to reflect the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, which provides enhanced guidance for using fair value to measure assets and liabilities. FASB ASC 820 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances.

However, FASB ASC 820 does not apply under accounting guidance that permits measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value, including FASB ASC 605-25, which is also referred to in this chapter.

pilots' and flight attendants' wages increase as their seniority grows and the size of the aircraft that they fly increases. These agreements usually result in higher wage scales for pilots and flight attendants who fly smaller aircraft for a major airline or a wholly owned subsidiary of a major airline than for pilots and flight attendants of independently owned regional airlines who do not fly larger aircraft. This condition, referred to as *regional carrier wage arbitrage*, has led to the growth of independently owned regional airlines.

9.03 The airline industry has also been affected by scope clauses in collective bargaining agreements at major airlines. These scope clauses frequently define the rules under which the major airline may expand through the use of regional jets either by the major airline itself, by wholly owned regional airlines, or by contracting with independent regional airlines. If a major carrier expands by contracting with a regional carrier, jobs that would have been associated with additional flying by the major carrier are lost to the regional airline. With the expansion of regional airlines (specifically regional jets in the 1990s), it became common for scope clauses to include a limit on the amount of flying that a major airline could contract to a regional airline, thus protecting the jobs of the major airline's employees. Scope clauses may include limits on the number of regional jets and the size of regional jets that may be flown by regional airlines (subsidiaries or contract carriers), or they may contain no such restrictions.

Revenue Sharing and the Evolution of Capacity Purchase Agreements

9.04 Revenue for passengers connecting from a regional carrier to a major carrier historically was split between the carriers in accordance with existing interline agreements (called *prorate agreements*), which typically prorated the revenue between the two carriers based on the distance that each carrier flew the passenger. These arrangements were highly beneficial to the major carriers because they provided not only a proportion of revenue received from the passengers' tickets but also a feed of local passengers into the major carrier's system. As a result, a number of the major carriers began acquiring regional airlines for the purpose of feeding their hubs. Once major carriers owned regional carriers, it became evident that cost reductions could be achieved by having the major carrier provide certain operational and administrative services for the regional carrier. Major airlines also saw a significant opportunity to expand the mission of their wholly owned regional subsidiaries to new markets and to provide more frequent service to existing markets by utilizing the regional carrier's smaller aircraft. As the benefit received by the major carriers went beyond revenue from the prorated ticket price, the benefit received by the regional carriers also evolved. The regional airlines sought to reduce their exposure to certain revenue and cost risks. Regional airlines achieved a reduction in risks associated with ticket price, load, and cost associated with ticket sales and fuel and facility costs by transferring them to the major carrier. New agreements were entered into that required the major airline to price and sell all tickets on the regional airline's flights through the major airline's distribution channels. These agreements effectively transferred all passenger-related activities to the major airline; the regional airline would be contracted to simply operate the aircraft between two points and would be reimbursed for the costs plus a specified margin associated with that activity. These agreements eventually evolved into today's capacity purchase agreements.

Revenue

Prorate Agreements

9.05 Some regional airlines today still fly pursuant to prorate agreements with other carriers. Under these agreements, the passengers' fare is split between the two carriers generally based on the distance traveled by the passenger on each airline. In some cases, particularly when the regional carrier is owned by the major carrier, the major carrier may use other methods to determine the prorate value of the ticket. However, prorate agreements between major airlines and regional airlines have evolved to meet the two parties' differing needs and now frequently include features such as fare minimums, connect incentives (fixed payments made by the major airline to the regional airline per passenger in addition to prorated revenue allocation), and other revenue incentives that help to minimize the revenue risk borne by the regional carrier.

9.06 Under prorate agreements, the regional carrier may be responsible for billing and collecting the value of the ticket from either the major carrier in the case of a code-share agreement or the ticketing carrier in the case of a standard interline agreement. Under prorate agreements, the airline that sells the ticket collects the fare from the passenger; the airline providing the transportation bills the collecting airline. This process is similar to interline billing between two airlines as discussed in chapter 3, "Marketing, Selling, and Providing Transportation," of this guide.

9.07 When regional airlines fly pursuant to prorate agreements, actual processing of tickets still takes place. The regional carrier may have its own revenue accounting department that processes all audit coupons and ticket lifts, or it may outsource some or all of this process. If the regional airline has its own revenue accounting department, revenue processing is similar to that of the major carriers (this is described in chapter 3 of this guide).

9.08 When the major carrier performs revenue processing for the regional carrier, it aggregates all revenue that it processed for passengers carried by the regional. Upon closing the month, the major carrier issues a report of all passengers carried by the regional carrier and the revenue allocated to the regional carrier. The regional carrier then bills this amount to the major carrier through the Airlines Clearing House. Alternatively, the major carrier may choose to settle with the regional carrier via regularly scheduled direct wire transfers. In such instances, the major carrier may pay the regional carrier throughout the month based on estimated allocated revenue and then settle at the end of the month based on actual allocated revenue. This process allows the regional carrier to obtain some of the cash flow timing benefit that it would enjoy if it were to sell the tickets itself.

9.09 Amounts billed to the major airline are often settled by netting revenue earned against the franchise fees paid to the major carrier for trademarks and marketing costs and the administrative cost for services performed by the major carrier for the regional carrier.

Capacity Purchase Agreements

9.10 Regional jet contracts between a major airline and a regional airline are frequently structured as capacity purchase agreements, which typically take one of two forms: fee-per-departure contracts or cost-based contracts.

These contracts are similar in that they both require a payment to cover the regional airline's operating costs on a block-hour or flight-hour basis. Under these contracts, the major carrier purchases the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the major airline, and the major airline also takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. Ground handling of the aircraft may be performed by either the major carrier or the regional airline.

Fee-Per-Departure Contracts

9.11 Under fee-per-departure contracts, the regional carrier is compensated based on a rate per departure. The rate is intended to cover all of the costs and a profit margin for operation of the specified flight. This rate is generally either a per departure amount (for a specified origin and destination) or an amount per block hour of operation. These contracts also frequently provide for incentive payments based on operational performance, passenger volumes, and customer service. Fee-per-departure contracts may be annual or long-term contracts. However, even long-term contracts are frequently adjusted annually to consider certain changes in operating costs. See "Other Contract Provisions" in this chapter for guidance on revenue recognition in situations in which negotiations for new rates are not completed by year end.

Cost-Based Contracts

9.12 Under cost-based contracts, the regional carrier is compensated generally based on specific costs it incurs plus a margin. Typically, the regional carrier's revenue consists of three elements: (*a*) reimbursement of costs over which the regional carrier has control, referred to as *controllable costs*; (*b*) reimbursement of costs over which the regional carrier typically has no control, referred to as *actual* or *pass-through costs*; and (*c*) a profit or margin component.

9.13 The following illustrates the types of revenue derived from the typical cost-based contract. It should be noted, however, that all contracts are designed to meet the objectives of the major and regional airlines involved and, accordingly, every contract is different and should be reviewed to ensure that proper accounting is being applied based on the contract terms.

Controllable Costs

9.14 Controllable costs typically are reimbursed by the major airline at a fixed rate applied to some measure of operations (for example, flight hours, passengers carried, cycles, or block hours). Because the rate is fixed, the regional airline is at risk for this category of costs and, if it does not manage its costs effectively, it will be less profitable. The following are examples of costs that are frequently included in this category, along with a brief description of each:

- *Crew wages*. Crew wages include costs associated with compensation of pilots and flight attendants on the aircraft. These costs may include the wages, benefits, per diems (meals and expenses), and lodging for each flight crew. Frequently, these costs are aggregated and expressed as a specific amount per flight hour.
- *Maintenance*. Maintenance includes costs required to maintain the aircraft. Maintenance cost is often computed based on the regional airline's history of performing maintenance on a given

fleet of aircraft subject to required Federal Aviation Administration maintenance schedules. Maintenance costs can also be derived from aircraft specifications and information from the aircraft vendors. Typical agreements provide for billing of maintenance costs to the major carrier based on a combination of fixed rates per flight hour, per departure, per aircraft, or other activity base. Regional airlines frequently outsource some or all of their aircraft maintenance activities. See "Regional Carriers' Revenue Recognition—Capacity Purchase Agreements" in this chapter for further discussion of this issue.

- *Ownership*. If the aircraft is owned, ownership costs include depreciation and interest on the aircraft. If the aircraft is leased, ownership costs include the lease payments on the aircraft. Ownership costs also include the cost of maintaining a spare parts inventory for the regional airline's fleet of aircraft and depreciation expense on rotable inventory. Ownership cost is typically reimbursed at a fixed amount per aircraft. See "Regional Carriers' Revenue Recognition—Capacity Purchase Agreements" in this chapter for further discussion of this issue.
- *Customer service and ground handling*. Customer service and ground handling costs include costs incurred by the regional airline in the ground handling of the aircraft, customer service, terminal fees, rents, and security at terminals. Ground handling costs include the wages and benefits of baggage handlers and the cost of the equipment at the stations (belt loaders and tugs). Customer service costs consist primarily of the wages and benefits paid to customer service representatives at ticket counters and boarding gates. Terminal fees and rents include all variable and fixed terminal rent paid by the regional carrier. Variable rents are incurred based on a measure of activity, such as passengers carried, and are typically for common use areas. Fixed rents are for terminal and gate space. Security costs include any security provided by the regional air carrier, airport, or the Transportation Security Administration that is paid for by the regional air carrier. In some contracts, terminal rent and security are treated as actual costs (see paragraph 9.16) that the regional carrier cannot control. In addition, the regional carrier may not incur some of these costs when operating at the major airline's hub airport or at other airports where the major airline performs customer service and ground handling services. See "Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net" in this chapter for a discussion of presentation of certain costs and revenue in the regional carrier's financial statements.
- *Overhead and administrative costs*. Overhead and administrative costs include compensation of employees who are not engaged in operational activities and facility costs, which include utilities and building maintenance. These costs may be reimbursed at a rate per activity measure, such as departures or passengers carried, or at a fixed amount per operations base.

9.15 Although crew wages are generally included in controllable costs, the other costs previously described may also be included in pass-through costs in some capacity purchase agreements.

Actual Costs (or Pass-Through Costs)

9.16 Actual costs typically are costs that are outside of the regional carrier's control (for example, fuel costs) and, therefore, are reimbursed by the major airline on an actual cost or pass-through cost basis (see "Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net" in this chapter for a discussion of presentation of certain costs and revenue in the regional carrier's financial statements). The following costs are typically reimbursed under capacity purchase agreements on an actual cost or pass-through cost basis:

- *Landing fees*. Landing fees are established by the airport and assessed against the airline based on the weight of the aircraft and the number of landings made in a given month—typically, the heavier the aircraft, the higher the fee.
- *Facility rentals*. Facility rental costs are the cost of using terminal and other facilities necessary for the regional flight to take off or land.
- *Fuel*. Fuel costs include the actual price per gallon of jet fuel, the associated fuel taxes, and the cost to put the fuel into the aircraft (referred to as *flow fees*).
- *Property taxes*. Property taxes include all property taxes on aircraft, terminals, spare parts, and equipment used directly to provide service under the contract.
- *Insurance*. Insurance costs include all costs of insuring the aircraft and passengers.

Costs Incurred by the Major Airline

9.17 The regional carrier may or may not be billed by the major carrier for certain products and services that the regional carrier obtains from the major carrier. These products and services tend to be the kinds of items that would typically be in the actual cost category, as well as customer service and ground handling in the major carrier's hub airport. Instead of billing the regional carrier for these items and then having the regional carrier bill them back, the major carrier may simply not bill the regional airline for these items. See the "Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net" discussion in this chapter.

Profit Component

9.18 Each cost-based contract may be unique in determining how the regional airline generates a profit from the services it performs. Profit may be derived from contractually stipulated performance bonuses based on the operations of the regional carrier and, conversely, profit may be diminished by stipulated performance penalties for not meeting established operational goals. Performance is usually measured by certain operating statistics, and bonuses are usually defined by bands of performance (the better the performance, the higher the bonus or, alternatively, poor performance can call for stipulated penalty payments by the regional carrier). In addition, profit on a regional contract is frequently derived by adding a margin or markup percentage to some or all controllable and actual costs. These markups sometimes also include so-called "margin collars," which serve to provide a floor and a cap to the amount of margin a regional carrier may earn either on an overall basis or on specific marginable cost categories. Alternatively, contracts may include only a margin cap. Care should be taken in analyzing contracts with margin collars because they may be interpreted differently by the parties.

Billing Process

9.19 Under capacity purchase agreements, regional airlines typically invoice their major airline partners using a two-step billing process that includes an estimated billing and a month-end billing that occurs shortly after month end (but generally before the books are closed) when the majority of statistics and cost information are determinable. Because some costs are more difficult to determine, so-called "true-up billings" frequently occur after the month end to finalize billings for a particular period. It should be noted that a difference can and frequently does occur in the amount of revenue recognized by the regional carrier and the amount billed to the major in that period. A typical difference that can arise relates to changes in the price of fuel. The initial billing is frequently based on an estimate of the average price of fuel; actual fuel prices often vary from this estimate. The difference in the amount billed and the actual revenue recorded is settled in the subsequent true-up billing. The regional carrier recognizes revenue based on its estimate of the amount earned under the contract in each period. However, reconciliation of payable and receivable positions and confirmation of periodic settlements of prior periods with the major airline is a key control to determine if revenue has been recorded properly.

Recording Revenue

9.20 Operating statistics are critical to the determination of revenue under a capacity purchase agreement. Depending on the contract terms, some of the statistics that can affect the determination of revenue include departures, block hours, number of aircraft, and passengers. Because an airline typically can identify actual statistics several days after month end, revenue to be recognized can be determined several days after month end as well. The following is a general summary of the process of recording revenue under capacity purchase agreements.

9.21 With fee-per-departure contracts, once actual flight statistics become known, they are multiplied by the rate per departure, flight hour, or other operating statistic to determine actual revenue. The difference between the amount invoiced to the major carrier and the actual revenue recognized is recorded as a receivable or payable from or to the major carrier at month end.

9.22 With cost-based contracts, revenue is determined based on flight statistics, actual costs, and performance goals. Once actual flight statistics become known, they are multiplied by the rates for each of the controllable costs to determine actual revenue from controllable costs. Occasionally, there are differences in the statistics used by the regional carrier and the major carrier, which result in differences in the reimbursement for controllable costs as computed by the regional carrier and by the major carrier. Such differences are resolved by the carriers by verifying the differences against recorded flight statistics to determine the correct amounts.

9.23 Because some actual costs may not be known at month end, regional carriers estimate and accrue them and estimate the related revenue based on the corresponding expense accruals. To the extent that the accrued expenses differ from actual costs incurred, the recorded revenue would differ as well, thus resulting in a profit or loss effect to the extent of any profit margin on such costs.

9.24 Revenue from incentives earned by achieving specified operational targets (performance bonuses) is recorded based on the regional carrier's operational performance during the measurement period specified in the contract. Revenue is recognized when the factors on which the incentive payments are based actually occur and are not subject to change. In situations in which the measurement period specified in the contract extends beyond the financial reporting period, terms and conditions of the specific contract need to be evaluated to determine if it is appropriate to recognize revenue related to future incentive payments during the financial reporting period. **(SEC)***[2]

9.25 According to the Securities and Exchange Commission (SEC) Staff Announcement: "Accounting for Management Fees Based on a Formula," in providing their views on revenue recognition under arrangements (other than those covered by Financial Accounting Standards Board [FASB] *Accounting Standards Codification* [ASC] 605-35) that contain a performance-based incentive fee that is not finalized until the end of a period of time specified in the contract, there are two acceptable methods of revenue recognition: (*a*) at the end of the incentive measurement period and (*b*) at any point in time for the amount that would be due under the formula as if the contract was terminated at that date. The second method may result in a reversal of revenue in a subsequent period if the incentive would no longer be due under the formula in that subsequent period. The staff of the SEC considers the first method to be the preferable accounting policy.

9.26 The amounts calculated for controllable costs are added to the estimate of revenue from actual costs and performance-related items, and the total is recorded as revenue for the month.

Accounting Issues

9.27 It should be noted that this chapter focuses on accounting issues that are unique to regional carriers. In addition to this chapter, regional carriers should refer to other chapters of this guide that address topics that are relevant for both regional and major carriers.

Regional Carriers' Revenue Recognition—Capacity Purchase Agreements

General Approach

9.28 FASB ASC 840-10 and 605-25 provide guidance on how regional airlines should analyze revenue recognition for capacity purchase agreements. The following is a brief overview of the analysis that the Financial Reporting Executive Committee (FinREC) believes should be performed for each capacity purchase agreement.

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[2] See paragraph 7.02.

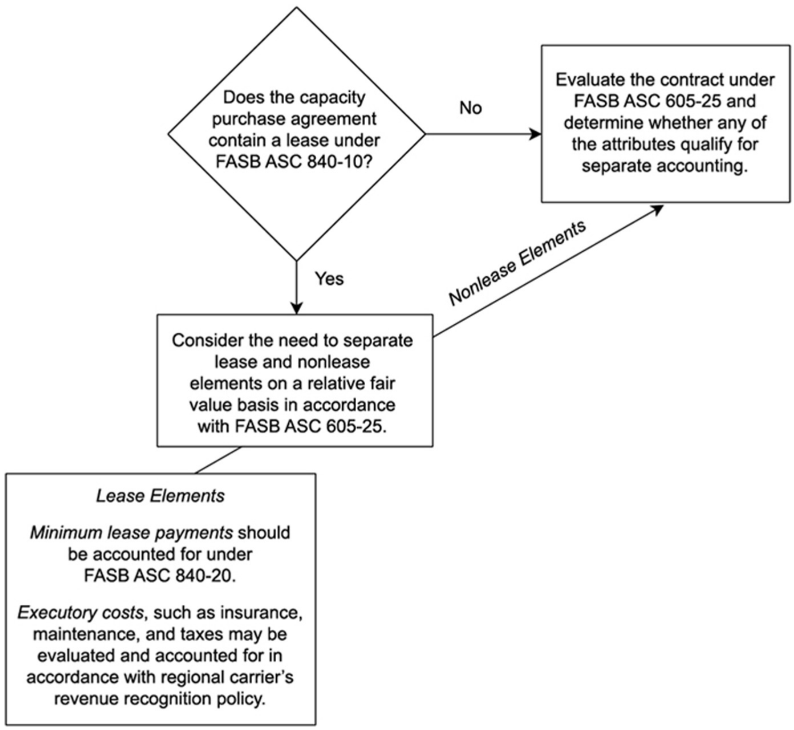
9.29 The first step in analyzing a capacity purchase agreement for revenue recognition purposes is to determine whether the agreement contains a lease under FASB ASC 840-10-15. If the portion of the agreement related to the use or acquisition of the aircraft qualifies as a lease under FASB ASC 840-10-15-19, the next step is to consider separation of lease and related executory costs from nonlease elements based on relative fair values in accordance with FASB ASC 605-25-15-3A(b). Lease and related executory cost elements are accounted for in accordance with FASB ASC 840-20-25. Nonlease elements are evaluated under FASB ASC 605-25-25 to determine if there are separate units of accounting and how each unit should be accounted for.

9.30 In practice, the terms of substantially all capacity purchase agreements (as described previously in this chapter) are such that the regional airline would generally conclude that a capacity purchase agreement contains a lease under FASB ASC 840-10-15. However, if it is determined that the capacity purchase agreement does not contain a lease or if FASB ASC 840-10-15 does not apply, the airline would apply the provisions of FASB ASC 605-25-25 to the entire contract. That would generally not result in multiple units of accounting because substantially all of the services provided under the capacity purchase agreement (for example, flight crew and planned major maintenance) would not meet the criteria in FASB ASC 605-25-25-5(a) to be considered separate units of accounting because their value is substantially dependent on delivery of the aircraft and because they would have no value to the customer on a standalone basis. FinREC believes that such capacity purchase agreements should be viewed as arrangements to transport passengers between two points, not arrangements to perform the separate activities necessary to operate the flight, and that the completion of a flight under such a capacity purchase agreement is the best measure of performance completion and is the appropriate time to recognize revenue for the flight. Services performed under such capacity purchase agreements by the regional airline for the major airline that are not part of the activities necessary to transport passengers may qualify for separation under FASB ASC 605-25-25 as discussed in the "Consideration of Lease Revenue Embedded in a Capacity Purchase Agreement" information that follows.

9.31 The remainder of the discussion in this chapter focuses on accounting for a capacity purchase agreement containing a lease under FASB ASC 840-10-15.

9.32 If the aircraft is considered leased under FASB ASC 840-10-15, and therefore ascribed to the major airline, the majority of the other services provided under the capacity purchase agreement could be separated for accounting evaluation by virtue of their having separate value to the major airline. Separation, if it occurred, would likely not result in recognition of revenue at a time other than the flight date for the majority of the services as described subsequently in this chapter. Separation might, however, result in revenue recognition at a different time for certain activities such as planned major maintenance based on its unique pattern of costs and delivery and additional accounting guidance that may apply to those services.

9.33 The flowchart that follows depicts the analysis of capacity purchase agreements. Guidance on application of this model is provided in the sections that follow.



Consideration of Lease Revenue Embedded in a Capacity Purchase

9.34 Per FASB ASC 840-10-15-10, two general criteria need to be considered when determining whether a capacity purchase agreement contains a lease. They are (*a*) whether fulfillment of the agreement depends on the use of specified property, plant, or equipment and (*b*) whether a right to control the use of the specified property, plant, or equipment is conveyed to the major airline under the capacity purchase agreement. The evaluation of whether these criteria are met is subjective; however, FASB ASC 840-10-15 contains specific considerations and FASB ASC 840-10-55 contains examples to assist in the evaluation.

9.35 Both criteria are typically met in regional airline capacity purchase agreements and, accordingly, payments received in connection with the use or acquisition of aircraft and related executory costs would generally be accounted for under FASB ASC 840, *Leases*. These criteria are met in most capacity purchase agreements because (*a*) the aircraft are dedicated to the major partner, including being painted in the major airline's colors and livery, and (*b*) although the regional airline may have a legal ability to operate the aircraft under its own code, the terms and operational requirements of the capacity purchase agreements generally make such operation impractical. Furthermore, to provide for operational continuation during scheduled maintenance activities or for other reasons, most capacity purchase agreements permit only a limited substitution of nonbranded aircraft. FinREC believes that FASB ASC 840 applies regardless of whether the aircraft is owned or leased by the regional airline and regardless of the form of capacity purchase agreement (that is, it applies to both fee-per-departure and cost-based contracts).

9.36 Under FASB ASC 840-10-15-19, the regional airline should first separate the portion of the capacity purchase agreement that pertains to the procurement of aircraft and related executory costs (lease costs) from the portion of the agreement that pertains to other than payments for a capital asset and related executory costs (that is, from payments for other services). The allocation of the arrangement consideration between lease and nonlease costs should be made in accordance with FASB ASC 605-25-15-3A(b), which is on a relative fair value basis using the entity's best estimate of the fair value of the deliverables. Determining the portion of the agreement related to the aircraft can be reasonably simple for cost-based contracts because the reimbursement for the aircraft is frequently specified in the contract on a per-flight-hour or per-month basis. Lease-related executory costs should also be separated as part of the process (executory costs are discussed subsequently in this section). However, if the amounts attributable to lease and nonlease costs are not readily determinable, as would generally be the case in the traditional fee-per-departure contract, the contract payments would need to be allocated using the regional airline's best estimate of fair value of the lease and nonlease costs in relation to other services provided under the capacity purchase agreement. Once the portion of the contract payments attributable to the aircraft and related executory costs is determined, that payment stream should be evaluated under FASB ASC 840-20-25. The minimum lease payments under the lease, excluding those for executory costs, should be evaluated under FASB ASC 840-10-25-1 to determine the proper classification of the lease.

9.37 FASB ASC 840-10-25-5 provides that executory costs such as insurance, maintenance, and taxes, together with any profit thereon, should be excluded from minimum lease payments. Therefore, executory costs would be separated from the costs related to the procurement of the aircraft.

9.38 As discussed in the "Revenue Recognition for Planned Major Maintenance Activities" information in this chapter, it is unclear whether payments related to planned major maintenance activities are considered executory costs as that term is used in FASB ASC-840-10-25. However, FinREC believes that even if such payments were not considered executory costs, they still would not meet the definition of minimum lease payments in paragraphs 5–7 of FASB ASC 840-10-25.

9.39 Determination of the lease term under a capacity purchase agreement can be difficult because these agreements are frequently long-term (for example, 10 to 20 years) but contain multiple provisions for termination by either party. In most cases, the lease term is either the full term of the agreement or the period when the agreement cannot be cancelled by the major carrier without cause (referred to herein as the *minimum contract period*). In determining whether the lease term should be based on the minimum contract period, the regional airline would need to consider penalties associated with cancellation of the contract. Such penalties may be monetary or economic (for example, if the major carrier has no substantially equivalent aircraft in its own fleet, canceling the capacity purchase agreement could force the major to downsize its operations due to inability to serve routes that require regional jets). If it is concluded that the minimum contract period should be used as the lease term, the regional airline would need to evaluate any cancellation provisions that could permit it to demand additional payments from the major.

These provisions may need to be considered as a component of minimum lease payments for the purpose of applying FASB ASC 840-10-25-1 to determine the proper classification of a lease.

9.40 Because each capacity purchase agreement is different, regional airlines need to evaluate the effect of FASB ASC 840-10 on the accounting for those contracts on a contract-by-contract basis.

Consideration of Multiple-Element Arrangements

9.41 After the separation of lease elements as previously described, the nonlease elements are then further evaluated under FASB ASC 605-25-25 to determine if there are separate units of accounting and how each unit should be accounted for under relevant generally accepted accounting principles.

9.42 FASB ASC 605-25-25-5 provides that, in an arrangement with multiple deliverables, the delivered item(s) should be considered a separate unit of accounting if all of the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis *if it is sold separately by any vendor* or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), this criterion does not require the existence of an observable market for that deliverable(s).
- If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

The criteria for dividing an arrangement into separate units of accounting should be applied consistently to arrangements with similar characteristics and in similar circumstances.

9.43 Based on the criteria set forth in the preceding list, the regional carrier should assess whether the delivered item has value on a standalone basis and specifically address whether any vendor sells that item separately. If the criteria are not met, the deliverable does not qualify to be accounted for as a separate unit of accounting.

9.44 Certain deliverables provided under a capacity purchase agreement that contains a lease, such as flight crew and fuel, could qualify as separate units of accounting under the guidance in FASB ASC 605-25-25 because they are likely to meet the criteria in FASB ASC 605-25-25-5. In particular, because the major airline is viewed as the operator of the aircraft (by virtue of being the lessee of the aircraft under FASB ASC 840-10), the provision of services under the contract by the regional carrier has value to the major airline because if the regional carrier did not provide those services, the major airline would have to obtain them elsewhere to operate the aircraft (for example, pay its own pilots to fly the aircraft or purchase fuel on its own). However, the application of FASB ASC 605-25-25-5 to these separate elements would likely not result in a different revenue recognition pattern because there is no separate revenue recognition literature that applies to these other flight-related components (for example, flight crew, fuel, and other services), and recognition as of flight completion would still generally be appropriate because the earnings process is complete at that point. The regional carrier would need to evaluate costs reimbursed under its capacity purchase agreement to ensure that this assessment is appropriate in its particular circumstances.

Revenue Recognition for Planned Major Maintenance Activities

9.45 Under most capacity purchase agreements, the major airline reimburses the regional airline for planned major maintenance, and these payments may not coincide with the performance of the maintenance services. As indicated previously, FinREC believes it is unclear whether payments related to planned major maintenance activities are considered executory costs as that term is used in FASB ASC 840-10-25-5. Furthermore, FASB ASC 840-10-25 does not provide guidance on how to account for executory costs. Therefore, FinREC believes there are two acceptable approaches to account for revenue related to planned major maintenance when the regional airline has concluded that a capacity purchase agreement contains a lease under FASB ASC 840-10: the regional airline may choose to account for maintenance-related revenue under a proportional performance method[3] or under the FASB ASC 840-20-25 approach as described subsequently. FinREC believes that a proportional performance method is preferable. Under both approaches, the lease and related executory costs (including the planned major maintenance activities) would be separated from the nonlease elements based on relative fair values as previously described. After that, the airline would apply one of the two accounting models that are discussed in the following sections.

Proportional Performance Approach

9.46 Under this model, because the customer (major airline) receives value from the performance of maintenance services throughout the term of the contract, it is believed that revenue is best recognized in proportion to those services being performed. FinREC believes that this method is effectively similar to the view expressed in question 1 of SEC Staff Accounting Bulletin (SAB) Topic 13-A.3(f), which states, in part

> the staff believes that upfront fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned.

9.47 Because maintenance services generally involve multiple actions that will be performed over a period of time, the regional airline would need to utilize a proportional performance method to measure when delivery of the maintenance services has occurred. The performance measure chosen would depend on the circumstances and could include input-based measures (such as labor hours or power-by-the-hour payments) or output-based measures (for example, the completion of a specific maintenance activity such as an overhaul

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[3] In 2008, as part of Emerging Issues Task Force (EITF) Issue No. 08-2, "Lessor Revenue Recognition for Maintenance Services," the EITF discussed the issue of how a lessor should account for payments it receives in connection with performing maintenance services to the leased item, in lease agreements or other arrangements accounted for as leases. The EITF never reached consensus and this issue was ultimately removed from the EITF agenda because of the concern that standard setting in this area could create additional complexity and would not provide users with better information. However, in one of its discussions, the EITF reached a tentative conclusion that revenue related to maintenance services should be recognized into income as those services are performed utilizing a proportional performance method that is determined to be the most appropriate method under the circumstances. Please refer to the FASB website at www.fasb.org/eitf/06-12-08_mtg_minutes.pdf for more information.

event). In circumstances in which a consistent level of maintenance services are performed evenly throughout the contract period (for example, the number of major maintenance events performed is expected to be consistent in each of the periods under the contract), the recognition of revenue on a proportional performance method may approximate recognition on a straight-line basis.

9.48 Capacity purchase agreements will often require the regional airline to perform various maintenance activities over a specified period, either implicitly or explicitly. Those maintenance activities could vary from routine recurring maintenance to significant overhauls of the leased asset. The contract may not stipulate how often the maintenance activity would need to occur, and the contract may provide for payment terms that do not necessarily mirror the performance of the specified maintenance services. Specifically, as described previously in this chapter, regional airlines frequently elect to be reimbursed for the planned major maintenance services as flight hours are incurred on the aircraft, whereas the performance of planned major maintenance activities generally occurs at scheduled intervals over the life of the leased asset. Because different capacity purchase agreements have different conditions and objectives, the determination of the most appropriate proportional performance method for each contract will be based on the facts and circumstances surrounding the contract.

9.49 FinREC believes this guidance could be applied at the capacity purchase agreement level or fleet type level (if the capacity purchase agreement specifies independent terms for different fleets).

9.50 Applying a proportional performance method could produce results that are similar to the FASB ASC 840-10-25 approach if it is concluded that services are performed ratably over the contract period. However, airlines likely to elect this approach are those that believe their pattern of performance is significantly different from straight-line and, as a result, believe proportional performance would provide a better model for recognizing revenue earned for planned major maintenance activities. The following examples are provided to illustrate how a regional airline might use the proportional performance model to account for planned major maintenance revenues:

- *Maintenance-related revenues are received* in proportion to the number of *planned major maintenance activities expected to occur in each period.* This may be the case in a contract covering a mature fleet that has relatively steady annual planned major maintenance activities over the lease term and consistent anticipated annual revenue under the capacity purchase agreement. This could also happen if revenues related to planned major maintenance are received on a pass-through basis (that is, as the related costs are incurred) and, therefore, directly match to the specific planned major maintenance activities on a per occurrence basis. In these situations, applying the proportional performance approach would result in revenue for planned major maintenance activities being recognized as received under the contract because revenue would be received for specific services performed.
- *Maintenance-related revenues are not received in proportion to planned major maintenance activities.* This might occur if a regional airline has a new fleet of aircraft that will require little or no planned major maintenance in the first few years and if the related capacity purchase agreement requires payments for

planned major maintenance activities on a basis that will be relatively stable over the lease term. In this example, when applying the proportional performance approach, the regional airline would likely defer revenue under the capacity purchase agreement and recognize it in proportion to planned major maintenance activities expected to be performed over the lease term.

9.51 The preceding examples are provided for illustrative purposes only and are not intended to cover all possible scenarios and outcomes. Therefore, specific facts and circumstances need to be carefully evaluated to ensure that the proportional performance model is applied based on the best measurement of planned major maintenance activities.

FASB ASC 840-20-25 Approach

9.52 Under this accounting model, FinREC believes revenue related to maintenance would be treated similarly to supplemental rent and would be recognized on a straight-line basis over the lease term. Under this approach, the regional airline would separate from the lease element the portion of the payments under the capacity purchase agreement related to planned major maintenance activities, including a profit thereon (the residual would then represent minimum lease payments to be accounted for under FASB ASC 840-10-25-1(d)). To accomplish this, a regional airline would generally estimate payments projected to be received for planned major maintenance activities over the lease term (including a profit thereon), which is typically based on the number of flight hours expected to be flown over this period. Then the airline would calculate a constant rate per flight hour, based on the estimated hours used to determine the total payments to be received. Because this calculation of hourly rate will require a number of variables to be estimated, airlines will need to review these variables at the end of each reporting period, or when facts and circumstances change significantly from those assumed in the calculation. FinREC recommends that regional airlines use a rate per flight hour or other appropriate measure of utilization of the aircraft to recognize revenue related to planned major maintenance under this method.

Special Considerations

9.53 If, at any time, the amount of recognized revenue related to planned major maintenance activities exceeds the amount of reimbursements received or receivable, the regional airline would need to evaluate realizability of the resulting receivable. Generally, the presumption is that collectability is not assured because the regional will only get paid by the major airline if it operates the flight in future periods, which may not be guaranteed. Therefore, FinREC believes that the regional airline should have evidence to overcome the presumption that collectability is not assured in order to be able to recognize revenue prior to receiving payment from the major airline.

Up-Front Contract Payments

9.54 When a regional airline enters into a new capacity purchase agreement with a major airline or, less frequently, when the contract is modified, for example, to include additional aircraft or make a significant modification to the service offering or model, the regional airline performs certain activities at the request of the major carrier to support the new contract or activities. These activities include, for example, painting the exterior and reconfiguring the interior of the aircraft to conform to the décor of the major airline and training customer service personnel in the use of the major airline's reservation system.

9.55 The cost of certain of these activities is often reimbursed by the major carrier pursuant to the capacity purchase agreement. Reimbursement may be paid at contract initiation, or it may be paid later. For example, costs associated with the integration of new aircraft into an existing contract would generally be paid as the aircraft are introduced.

9.56 As discussed previously, the regional carrier needs to evaluate activities described in the preceding paragraphs of this section under FASB ASC 605-25-25 to determine whether they qualify to be accounted for as separate units of accounting. Generally, in a capacity purchase agreement that contains a lease (which is the most prevalent structure of those arrangements), services provided by the regional to prepare its aircraft for operations for the major carrier and to train its employees would not qualify as separate units of accounting under FASB ASC 605-25-25 because they would have no value to the major carrier on a standalone basis. For example, in the case of training, the regional carrier is training its own pilots who will operate planes for the major carrier. Trained pilots of the regional carrier have no value to the major carrier absent the regional carrier's performance under the contract. However, if the regional carrier trains pilots working for the major carrier, those trained pilots would have value to the major carrier on a standalone basis because they could be used by the major carrier on its other aircraft, and the training deliverable would qualify as a separate unit of accounting.

9.57 Furthermore, the guidance in SAB No. 104, *Revenue Recognition*, with respect to nonrefundable up-front fees would likely result in the deferral of revenue. SAB No. 104 states that

> the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned.

9.58 FinREC believes that the major carrier pays the up-front fees for services provided by the regional carrier (for example, training or painting the aircraft) solely to facilitate the provision of flights under the capacity purchase agreement and that, as such, the provisions of SAB No. 104 should be applied, which, in most cases, would result in revenue recognition over the term of the capacity purchase agreement for such up-front payments.

9.59 The nature of direct costs associated with providing these services would need to be evaluated to determine whether they should be capitalized or expensed. For example, costs incurred to paint the exterior and reconfigure the interior of the aircraft to conform to the décor of the major airline might be either expensed or capitalized depending on the airline's asset capitalization policy for its aircraft, as discussed in chapter 4, "Acquiring and Maintaining Property and Equipment." The regional airline should be aware that the useful lives of any capital assets may be affected by the term of the contract or other contractual provisions (for example, if the initial painting of the aircraft in the major airline's color scheme is determined to be a capital asset, its life would generally be limited to the contract term).

9.60 Some costs incurred by the regional airline for which it is reimbursed by the major airline as part of up-front contract payments (for example, training) may not qualify for capitalization. This may result in revenue from up-front payments being deferred and amortized over the contract term, whereas the related expense would be recognized in earnings when incurred. However, in situations in which the regional airline concludes that the revenue should be deferred, other types of costs (for example, training and aircraft reconfiguration costs that are not capitalizable under the airline's asset capitalization policy) may qualify for capitalization as an asset provided that they meet the requirements of FASB ASC 340-10-25-3, which states that if a contractual guarantee for reimbursement exists for design and development costs that otherwise would be expensed under the requirements of FASB ASC 340-10-25, those costs should be recognized as an asset as incurred. For purposes of the guidance in FASB ASC 340-10-25, contractual guarantee means a legally enforceable agreement in which the amount of reimbursement can be objectively measured and verified.

9.61 This provision would generally be met in situations in which the reimbursement is received up-front or the contract specifically provides for such reimbursement in the future, including upon a contract termination. The capitalized costs would generally be amortized over the contract period in proportion to the revenue recognized, provided the transaction meets the criteria for gross reporting under FASB ASC 605-45-45-1.

Presentation of Revenue and Expenses Under Capacity Purchase Agreements—Gross Versus Net

9.62 Industry practice among the regional airlines for capacity purchase agreements is uniform, with revenue and expenses generally reported on a modified gross basis (that is, revenue reflects amounts billed to the major carrier under the capacity purchase agreement, and operating expenses are reported by separate category in operating expenses).

9.63 Regional airlines traditionally have recognized as an expense the costs incurred by the major carrier in connection with the operation of the major carrier's flight if the major carrier billed the regional for those costs and if they recognized revenue for the amount rebilled to the major (gross presentation). However, if the regional was not billed by the major for those costs, the regional recognized neither the expense nor the related revenue (net presentation). For example, if the regional carrier used its major partner's terminal space at the major carrier's hub location, the major carrier billed the regional for the terminal space, and the regional rebilled the major for that cost (generally as a component of actual or pass-through costs under the capacity purchase agreement), the regional would recognize the expense and related revenue in its statement of operations. However, if the regional was not billed by the major for the use of that space (that is, the major simply absorbed the cost of facilities used by the regional and did not bill the regional at all), the regional airline's statement of operations would exclude that expense and related revenue. As a result, costs such as fuel, facilities, ground handling, and landing fees have been treated differently among regional carriers depending on the terms of the contract between the regional and major airline. It should be noted that expenses incurred by the major in connection with activities not performed by the regional under a capacity purchase agreement are attributed to the major and are not billed to the regional. For example, under a typical capacity purchase agreement, the regional must simply operate the aircraft from one point to another point and has no obligation to sell tickets. Accordingly, costs related to ticketing such as commissions and computer reservations systems would not be within the scope of services provided by the regional under the capacity purchase agreement, would not relate to the services performed by the regional, would be incurred by the major, and would not be recognized by the regional as expenses or revenue.

9.64 FinREC believes that, in determining whether pass-through costs should be presented gross or net, regional carriers should follow the guidance in FASB ASC 605-45-45-1. Gross versus net presentation is a matter of judgment that depends on the relevant facts and circumstances. FASB ASC 605-45-45 sets forth factors or indicators that should be considered in that evaluation. Accordingly, regional carriers would need to consider the terms of the capacity purchase agreement as well as the nature and terms of the underlying contracts to acquire services that are reimbursed by the major carrier. That would include pass-through costs incurred by the major carrier that pertain directly to the scope of operations prescribed under the capacity purchase agreement and that are necessary for the completion of the operation of the flight. Each kind of pass-through cost would need to be evaluated individually.

9.65 None of the factors or indicators set forth in FASB ASC 605-45-45 is considered presumptive or determinative; the relative strength of each indicator should be considered. However, FinREC believes that, in the context of pass-through costs under capacity purchase agreements, certain factors are likely to be more significant than others. Those factors are discussed in the paragraphs that follow. FinREC believes the guidance in those paragraphs is also supported by paragraphs 22–23 of FASB ASC 605-45-45.

Indicators of Gross Revenue Reporting

9.66 *Regional has supplier discretion*. If the regional airline has discretion in selecting the supplier to provide the services whose cost would be the basis for revenue recognition, that may indicate that the regional is primarily responsible for the fulfillment of those services, and that the regional should present revenue and expense gross. In these situations, the regional frequently has other indicators of gross presentation as well, such as being the primary obligor to the supplier.

9.67 *Regional is the primary obligor*. The regional airline is the primary obligor if it contracts for the service and performs substantially all execution actions under the contract, which would generally include being obligated to pay for the contract. For example, regional airlines frequently purchase fuel directly at outstations from the local airport fuel provider and are then reimbursed for the cost of the fuel by the major airline. In these transactions, the regional airline is the primary obligor because it executes a purchase contract with the fuel provider and pays for the fuel.

9.68 *Regional has credit risk*. The regional airline would generally have credit risk for services purchased if it must pay the amount owed to a supplier after the supplier performs, regardless of whether it is reimbursed fully by the major airline.

9.69 Paragraphs 5–9, 11, and 12 of FASB ASC 605-45-45 provide additional indicators that should be considered in determining whether a regional should report revenue and expense gross, such as whether the regional changes the product or performs part of the service, whether the regional has general inventory risk—before customer order is placed or upon customer return, whether the regional has latitude in establishing price, whether the regional is involved in the determination of product or service specifications, or whether the regional has physical loss inventory risk—after customer order or during shipping.

Indicators of Net Revenue Reporting

9.70 Paragraphs 15–18 of FASB ASC 605-45-45 provide guidance and indicators that should be considered in determining whether a regional should report revenue and expense net, such as whether the entity's supplier is the primary obligor in the arrangement, whether the amount the entity earns is fixed, and whether the supplier has credit risk.

9.71 *Lack of supplier discretion*. If the regional airline is directed by its contract with the major airline to procure services from a particular vendor with no ability to change vendors, that may indicate that the regional is not primarily responsible for the operating expenses that would be the basis for revenue recognition, and that the cost of those services and the related revenue should be reported net. For example, if the capacity purchase agreement requires that certain services be obtained only from the major partner, the cost of those services and the related revenue would generally meet the requirements for net presentation. Lack of supplier discretion may result from economic compulsion as well as from contractual restrictions.

9.72 *Major is the primary obligor*. If the major airline is the primary obligor in a supplier agreement under which the regional airline procures goods or services, including arrangements under which the supplier would look directly to the major airline for settlement, that is strong evidence of net reporting.

9.73 FinREC believes that the primary obligor and supplier discretion are the main criteria in the determination of gross versus net presentation of pass-through costs. However, absence of one of the indicators in the relationship with the major airline does not always indicate that the agreement should be presented on a net basis in the regional airline's financial statements.

Disclosures

9.74 See chapter 7, "Financial Reporting and Disclosures," of this guide for disclosure considerations related to presentation of revenue and expenses under capacity purchase agreements.

Other Contract Provisions

Annual Contract Component Negotiations

9.75 Long-term fee-per-departure contracts generally establish base rates that are subject to annual adjustment for certain cost components. Most contracts allow the regional airline to continue billing the major airline at the currently agreed rates while new annual rates are being negotiated until the new rates are finalized. FinREC recommends that regional airlines follow the guidance in SAB No. 104 in recognizing revenue during the negotiation period. Fixed or determinable sales price is one of the revenue recognition criteria discussed in SAB No. 104. FinREC believes that situations in which the rates are expected to decline and the regional carrier may be required to refund the major carrier for the difference in rates during the negotiation period are similar to price concessions discussed in FASB ASC 926-605-25. Consistent with the guidance in FASB ASC 926-605-25, FinREC believes that airlines should provide appropriate allowances for such refunds. If rates are expected to increase, the regional airline generally continues to bill and recognize revenue under the terms of the previous agreement until such increases in rates are formally agreed to. Rates are considered to be "formally agreed to" when there is persuasive evidence of an arrangement. As part of the regional airline's revenue recognition policy, if adjustments from the prior contract are made based on management's judgment, that fact would need to be disclosed.

Termination Provisions

9.76 Capacity purchase agreements typically include termination provisions under which the major carrier or the regional carrier may early-terminate the agreement. For the major carrier, these provisions typically involve standards of performance to which the regional carrier must adhere, including on-time performance, completion percentage, baggage handling, or other conditions such as changes in control and financial viability. For the regional carrier, termination provisions may include requirements concerning the timing of payments and the continued viability of the major carrier.

9.77 To alleviate certain financial and operational risks associated with these termination provisions, capacity purchase agreements may also contain provisions for "puts" and "calls" on the aircraft that the regional carrier is flying in service for the major carrier. Because it is typically the regional carrier's responsibility to procure and finance the aircraft flown under capacity purchase agreements, and because the useful life of owned aircraft and lease term for leased aircraft often exceed the term of the capacity purchase agreement between the regional carrier and the major carrier, the regional carrier has cost exposure for the useful life or lease term that exceeds the term of the capacity purchase agreement. A remedy for this exposure is to include "put" terms in the agreement whereby the regional carrier has the option to require the major carrier to assume the lease of the underlying aircraft in certain situations including contract termination. The opposite situation may also occur in which the major carrier desires to continue the use of the regional carrier's aircraft after contract termination, whether early or not. A remedy to the major carrier in this case is to include "call" terms in the agreement, under which the major carrier has the option to require the regional carrier to sell or transfer the lease of the underlying aircraft to the major carrier. The existence of the provisions and the conditions that could result in these contingencies would need to be disclosed clearly in the notes to the financial statements. Also, put and call provisions should be evaluated to determine if they are in substance residual value guarantees or bargain purchase options for purposes of applying FASB ASC 840-10-25-29 to determine the proper classification of a lease. The terms of call provisions may affect the regional carrier's depreciation and lease accounting if the regional carrier leases the aircraft.

Inherent Risk Factors

9.78 Factors that influence inherent risk related to regional carriers' revenue recognition under capacity purchase agreements might include the following:

- Accounting for capacity purchase agreements requires significant estimation because some of the actual costs may not be known at month end due to delays in the billing process at vendors.
- A high degree of manual involvement in recording capacity purchase agreement transactions.
- Capacity purchase agreements are typically lengthy and complex documents that often contain terms that are subject to interpretation by both the regional carrier and the major carrier. Differences in interpretation may lead to billing disputes and collection issues.
- Discrepancies may exist among multiple information systems that capture and store actual flight statistics that represent the largest single determinant of contract billings.
- Heavy dependence of regional carriers on the stability of their major airline partners.
- Collectability of accounts receivable may not be assured due to existence of disputes or deteriorating credit worthiness of the major airline partner.

Chapter 10

Special Reports and Example Reporting

Passenger Facility Charges

10.01 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 PFCs from more than 50,000 passengers (that is, passengers boarded at airports that assess PFCs) to provide 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." In July 2002, the FAA issued the Passenger Facility Charge Audit Guide for Air Carriers (the PFC Audit Guide). The PFC Audit Guide provides auditors with a comprehensive set of procedures for examining air carrier's PFC collection, remittance, and reporting practices. The PFC Audit Guide is not intended to define the sole method of complying with the audit requirements. The PFC Audit Guide also recommends that auditors perform certain agreed-upon procedures that are set forth in the PFC Audit Guide and report on such agreed-upon procedures. This agreed-upon procedures report is not required, but may provide additional assurance regarding the carrier's controls over processing PFCs, which may reduce the possibility that an airport authority would audit the carrier's PFC reporting. 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. The PFC Audit Guide is available on the FAA website at www.faa.gov/airports/pfc/audit_guides/media/air_carriers_audit.pdf. The FAA expects these reports to be filed in a timely manner, and the filing should normally coincide with the carrier's fiscal year and its corporate audit cycle. Therefore, there is no specific due date as set forth in the PFC Audit Guide.

Reporting on PFC Schedules

Illustrative Audit Report on PFC Schedules

10.02

Independent Auditor's Report

Board of Directors

XYZ Airline, Inc.:

We have audited the accompanying Schedules of 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, 20XX (the Schedules). The Schedules are the responsibility of the management of XYZ Airline, Inc. Our responsibility is to express an opinion on the Schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the Federal Aviation Administration Passenger Facility Charge Audit Guide for Air Carriers. 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 [14 *Code of Federal Regulations* Part 158] to implement Title 49, *United States Code*, Sections 46110 and 40117, as amended. 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, 20XX, 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., the appropriate airport authorities, and the Federal Aviation Administration, and is not intended to be and should not be used by anyone other than these specified parties.[1]

[*Signature*]

[*Date*]

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[1] Paragraph .08 of AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*), provides that when, in accordance with paragraph .06 of AU-C section 905, the auditor includes an alert that restricts the use of the auditor's written communication to certain specified parties, and the auditor is requested to add other parties as specified parties, the auditor should determine whether to agree to add the other parties as specified parties. Paragraph .A5 of AU-C section 905 explains that an auditor's written communication that is required by paragraph .06 of AU-C section 905 to include an alert that restricts its use may be included in a document that also contains an auditor's written communication that is for general use. In such circumstances, the use of the general use communication is not affected.

Illustrative Year-End and Quarterly Schedules Filed With the PFC Audit Opinion

10.03 The following are examples of the year-end and quarterly schedules that are filed with the PFC Audit Opinion. Each is an excerpt from these schedules because the schedules contain PFC information for all qualifying airports that the carrier provides service to.

XYZ Airline, Inc.
Schedule of Passenger Facility Charges Collected, Refunded, Withheld, and Remitted
For The Year Ended December 31, 20XX

Public Agency		*Amounts Collected*	*Amounts Refunded*	*Amounts Withheld*	*Net Amount*	*Amount Remitted*	*Difference Between Net Amount and Amount Remitted (if Any)*
Allentown PA USA	(ABE)	1,922	243	47	1,632	1,632	—
Abilene TX USA	(ABI)	272,403	25,709	6,659	240,036	240,036	—
Albuquerque NM USA	(ABQ)	1,199,859	113,493	43,995	1,042,371	1,042,371	—
Aberdeen SD USA	(ABR)	329	36	8	284	284	—
Albany GA USA	(ABY)	981	54	24	903	903	—
Waco TX USA	(ACT)	238,095	26,717	5,820	205,558	205,558	—
Eureka/Arcata CA USA	(ACV)	1,737	216	42	1,479	1,479	—
Atlantic City NJ USA	(ACY)	240	39	9	192	192	—
Alexandria LA USA	(AEX)	4,869	635	119	4,115	4,115	—
Augusta GA USA	(AGS)	1,998	342	49	1,607	1,607	—
Albany NY USA	(ALB)	158,601	16,524	5,815	136,262	136.262	—
Waterloo IA USA	(ALO)	185	27	5	153	153	—
Alamosa Colorado	(ALS)	87	9	3	75	75	—

Public Agency		*Amounts Collected*	*Amounts Refunded*	*Amounts Withheld*	*Net Amount*	*Amount Remitted*	*Difference Between Net Amount and Amount Remitted (if Any)*
Walla Walla WA USA	(ALW)	810	95	20	696	696	—
Anchorage AK USA	(ANC)	170,394	17,463	6,248	146,683	146,683	—
Altoona PA USA	(AOO)	231	27	8	196	196	—
Alpena MI USA	(APN)	77	6	3	68	68	—
Aspen CO USA	(ASE)	3,492	581	85	2,826	2,826	—
Atlanta GA USA	(ATL)	4,677,359	490,374	114,335	4,072,649	4,072,649	—
Appleton WI USA	(ATW)	3,336	276	122	2,938	2,938	—
Austin TX USA	(AUS)	4,770,108	541,422	116,603	4,112,083	4,112,083	—
Asheville NC USA	(AVL)	3,218	464	79	2,675	2,675	—
Kalamazoo MI USA	(AZO)	168,308	15,662	4,126	148,520	148,520	—
Bradford PA USA	(BFD)	117	23	3	92	92	—
Scottsbluff NE USA	(BFF)	252	14	6	232	232	—
Bakersfield CA USA	(BFL)	3,812	419	93	3,300	3,300	—
Binghamton NY USA	(BGM)	905	90	22	792	792	—

(continued)

Public Agency		Amounts Collected	Amounts Refunded	Amounts Withheld	Net Amount	Amount Remitted	Difference Between Net Amount and Amount Remitted (if Any)
Bangor ME USA	(BGR)	129,894	10,938	4,763	114,193	114,193	—
Birmingham AL USA	(BHM)	328,698	31,821	12,052	284,825	284,825	—
Billings MT USA	(BIL)	2,421	291	89	2,041	2,041	—
Bismarck ND USA	(BIS)	1,481	257	36	1,188	1,188	—
Bemidji MN USA	(BJI)	158	5	4	149	149	—
Bellingham WN USA	(BLI)	3,249	419	79	2,751	2,751	—
Bloomington IL USA	(BMI)	251,685	26,600	6,152	218,933	218,933	—
Nashville TN USA	(BNA)	1,992,813	199,389	73,070	1,720,354	1,720,354	—
Boise ID USA	(BOI)	80,132	8,258	1,959	69,915	69,915	—
Boston MA USA	(BOS)	8,835,714	1,083,255	295,273	7,457,186	7,457,186	—
Beaumont TX USA	(BPT)	1,229	149	30	1,050	1,050	—

XYZ Airline, Inc.
Schedule of Passenger Facility Charges Collected, Refunded, Withheld, and Remitted for Each Quarter During the Year Ended December 31, 20XX

Public Agency	*Amounts Collected*	*Amounts Refunded*	*Amounts Withheld*	*Net Amount*	*Amount Remitted*	*Difference Between Net Amount and Amount Remitted (if Any)*
Allentown PA USA						
Quarter Ended March 31, 20XX	513	63	13	437	437	—
Quarter Ended June 30, 20XX	410	32	10	368	368	—
Quarter Ended September 30, 20XX	527	68	13	446	446	—
Quarter Ended December 31, 20XX	473	81	12	380	380	—
Abilene TX USA						
Quarter Ended March 31, 20XX	64,422	5,558	1,575	57,290	57,290	—
Quarter Ended June 30, 20XX	69,053	6,107	1,688	61,258	61,258	—
Quarter Ended September 30, 20XX	73,179	7,101	1,789	64,289	64,289	—
Quarter Ended December 31, 20XX	65,750	6,944	1,607	57,199	57,199	—

(continued)

Public Agency	*Amounts Collected*	*Amounts Refunded*	*Amounts Withheld*	*Net Amount*	*Amount Remitted*	*Difference Between Net Amount and Amount Remitted (if Any)*
Albuquerque NM USA						
Quarter Ended March 31, 20XX	307,284	24,198	11,267	271,819	271,819	—
Quarter Ended June 30, 20XX	327,336	28,365	12,002	286,969	286,969	—
Quarter Ended September 30, 20XX	323,820	32,088	11,873	279,859	279,859	—
Quarter Ended December 31, 20XX	241,419	28,842	8,852	203,725	203,725	—
Aberdeen SD USA						
Quarter Ended March 31, 20XX	72	—	2	70	70	—
Quarter Ended June 30, 20XX	50	18	1	30	30	—
Quarter Ended September 30, 20XX	144	18	4	122	122	—
Quarter Ended December 31, 20XX	63	—	2	61	61	—
Albany GA USA						
Quarter Ended March 31, 20XX	95	27	2	65	65	—

Public Agency	*Amounts Collected*	*Amounts Refunded*	*Amounts Withheld*	*Net Amount*	*Amount Remitted*	*Difference Between Net Amount and Amount Remitted (if Any)*
Quarter Ended June 30, 20XX	90	9	2	79	79	—
Quarter Ended September 30, 20XX	90	14	2	74	74	—
Quarter Ended December 31, 20XX	707	5	17	685	685	—
Waco TX USA						
Quarter Ended March 31, 20XX	60,809	6,399	1,486	52,923	52,923	—
Quarter Ended June 30, 20XX	60,044	6,467	1,468	52,109	52,109	—
Quarter Ended September 30, 20XX	65,232	7,281	1,595	56,356	56,356	—
Quarter Ended December 31, 20XX	52,011	6,570	1,271	44,170	44,170	—
Eureka/Arcata CA USA						—
Quarter Ended March 31, 20XX	648	90	16	542	542	—
Quarter Ended June 30, 20XX	—	—	—	—	—	—
Quarter Ended September 30, 20XX	846	63	21	762	762	—
Quarter Ended December 31, 20XX	243	63	6	174	174	—

Reporting on Internal Control Over Administering PFCs

Illustrative Report on Internal Control Over Administering PFCs (Attestation Standards)

10.04

Independent Auditor's Report[2]

Board of Directors
XYZ Airline, Inc.

We have examined management's assertion, included in the accompanying [title of management report],[3] that XYZ Airline, Inc. maintained effective internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 20XX, for the purpose of complying with the regulations issued by the Federal Aviation Administration of the Department of Transportation [14 *Code of Federal Regulations* Part 158] to implement Title 49, *United States Code*, Sections 46110 and 40117, as amended, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. XYZ Airline, Inc.'s management is responsible for maintaining effective internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted. Our responsibility is to express an opinion on management's assertion based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and the Federal Aviation Administration Passenger Facility Charge Audit Guide for Air Carriers and, accordingly, included obtaining an understanding of the internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted, assessing the risk that a material weakness exists, testing, and evaluating the design and operating effectiveness of the internal control. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity's internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable schedules

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[2] This illustrative report is to be used when a practitioner expresses an opinion on management's assertion about the effectiveness of an entity's internal control. This report is based upon AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*). Practitioners should refer to AT section 501 for guidance when expressing an opinion on management's assertion about the effectiveness of an entity's internal control.

[3] The practitioner should identify the responsible party's report examined by referring to the title used by the responsible party in its report. Further, he or she should use the same description of the entity's internal control as the responsible party uses in its reports, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which the responsible party is reporting. If the presentation of the assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of responsible party's report*]" would be omitted. For example, certain carriers include management's assertion on the effectiveness of internal controls over administering passenger facility charges (PFCs) collected, withheld, refunded or exchanged, and remitted in the management representation letter. In this fact pattern, the auditor's opinion would refer to the management representation letter. An example of management's assertion on the effectiveness of internal control over processing PFCs is included in this chapter.

in accordance with the regulations issued by the Federal Aviation Administration of the Department of Transportation [14 *Code of Federal Regulations* Part 158] to implement Title 49, *United States Code*, Sections 46110 and 40117, as amended, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. An entity's internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of schedules in accordance with the regulations issued by the Federal Aviation Administration of the Department of Transportation [14 *Code of Federal Regulations* Part 158] to implement Title 49, *United States Code*, Sections 46110 and 40117, as amended, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and that transactions of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized transactions that could have a material effect on the schedules.

Because of limitations inherent internal control may not prevent or detect and correct misstatements. Also, projections of any evaluation of the internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the controls may deteriorate.

In our opinion, XYZ Airline, Inc. maintained, in all material respects, effective internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 20XX, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.[4]

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc., the appropriate airport authorities, and the Federal Aviation Administration and is not intended to be and should not be used by anyone other than these specified parties.[5]

[*Signature*]

[*Date*]

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[4] See paragraphs .100–.106 of AT section 501 for reporting when the examination discloses significant deficiencies that, individually or in combination, result in one or more material weaknesses.

[5] In accordance with paragraph .79 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), a practitioner should consider informing his or her client that restricted-use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general-use report. Footnote 16 to paragraph .79 of AT section 101 further provides that in some cases, restricted-use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. However, according to AT section 101 paragraph .79, a practitioner is not responsible for controlling a client's distribution of restricted-use reports. Accordingly, a restricted-use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

Illustrative Management's Assertion on the Effectiveness of Internal Control Over Processing PFCs

10.05 The following is an example of the management's assertion on the effectiveness of internal control over processing PFCs that would be included in a separate report or management representation letter.

Management's Assertion

In connection with your attestation engagement relating to our assertion that XYZ Airlines, Inc. (the Company) maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 20XX, for the purpose of complying with the regulations issued by the Federal Aviation Administration of the Department of Transportation [14 *Code of Federal Regulations* Part 158] to implement Title 49, *United States Code*, Sections 46110 and 40117, as amended, we recognize that obtaining representations from us concerning the information contained in this letter is a significant procedure in enabling you to form an opinion about whether our assertion is fairly stated in all material respects based upon the criteria specified in our assertion. We further recognize that, as members of management of the Company, we are responsible for establishing and maintaining an effective internal control structure over administering passenger facility charges. Internal control over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified. Because of inherent limitations in any internal control, no matter how well-designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management has performed an evaluation of the Company's internal control policy and procedures to ensure the Company's procedures are reasonable and fair for collecting, holding, and dispersing passenger facility charges based on the control criteria established by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation, we assert that the internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted was effective during the period from January 1, 20XX through December 31, 20XX.

Illustrative Agreed-Upon Procedures Report Related to a Carrier's Evaluation of Its Compliance With the Requirements of 14 Code of Federal Regulations Part 158

10.06

Independent Accountant's Report on Applying Agreed-Upon-Procedures[6]

Board of Directors
XYZ Airline, Inc.

We have performed the procedures enumerated below, which were agreed to by the Federal Aviation Administration (FAA), XYZ Airline, Inc., and the applicable airport, solely to assist the specified parties in evaluating XYZ Airline's, Inc. compliance with the requirements of 14 *Code of Federal Regulations* Part 158, "Passenger Facility Charges" during the year ended December 31, 20XX. Management is responsible for XYZ Airline, Inc.'s compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.]

We were not engaged to, and did not, conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc., the appropriate airport authorities, and the FAA and is not intended to be and should not be used by anyone other than these specified parties.[7]

[*Signature*]

[*Date*]

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[6] This illustrative report is to be used when a practitioner is engaged to perform agreed-upon procedures related to PFCs. This report is based upon AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*). Practitioners should refer to AT section 601 for further guidance.

[7] See footnote 5.

Immigration and Naturalization Services

10.07 The Immigration and Naturalization Service (INS) charges a fee on each international ticket, which is collected by the air carriers for the immigration inspection of each passenger aboard a commercial aircraft arriving at a port-of-entry in the United States, or for the preinspection of a passenger in a place outside the United States prior to such arrival, depending on the point of origin. Annually, each U.S. carrier that retains an independent accountant and remits $10,000 or more in fees in any 1 calendar quarter should submit to the INS a report from the independent accountant in accordance with the Statements on Standards for Attestation Engagements established by the AICPA on the application of Passenger User Fee Collection and Remittance Procedures. Each foreign-based remitter should submit a similar report from the independent accountant. These reports from the independent accountants are to be submitted no later than 90 days after the close of the fiscal year of the air carrier.

Illustrative Agreed-Upon Procedures Report on INS Schedules

10.08

Independent Accountants' Report on Applying Agreed-Upon-Procedures[8]

The Board of Directors and Management of XYZ Airlines, Inc. and Immigration and Naturalization Services

We have performed the procedures enumerated below, which were agreed to by the management of XYZ Airlines, Inc. and Immigration and Naturalization Services, solely to assist you in evaluating the accompanying Statement of INS Immigration User Fees Collected and Remitted by XYZ Airlines, Inc for the year ended December XX, 20XX (the statement). XYZ Airlines', Inc. management is responsible for the statement. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose. We were informed by officials of XYZ Airlines, Inc., who have responsibility for accounting and financial matters, that the statement is presented on the basis prescribed by the Immigration and Naturalization Service Rule regarding Immigration User Fees.

Our procedures and findings are as follows:

1. We compared each of the amounts (except for the totals) in the statement under the column "Collections Per Ledger" to the sum of collections and other activity, excluding payments, in general ledger account XX-XX-XX, Immigration User Fees and found them to be in agreement.
2. We compared each of the amounts, dates, and check numbers in the statement under the columns "Tax Paid," "Remittance Date,"

[8] This illustrative report is to be used when a practitioner is engaged to perform agreed-upon procedures related to Immigration and Naturalization Service schedules. This report is based upon AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). Practitioners should refer to AT section 201 for further guidance.

and "Check Number" to the corresponding amounts, dates, and check numbers included on the copies of canceled checks made payable to the Immigration and Naturalization Service—Office of the Comptroller and found them to be in agreement for the first, second, third, and fourth quarter payments.

3. We compared the amounts on the copies of canceled checks referred to in the preceding paragraph with the corresponding amounts included on the related bank statement in the month the check cleared the bank and found the amounts to be in agreement.

4. We footed the amounts in the statement under the column "Collections Per Ledger" for each month in each quarter and found them to be in agreement with the amount listed as the "Quarter Total."

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on the statement. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of XYZ Airlines, Inc. and the Immigration and Naturalization Service, and is not intended to be and should not be used by anyone other than these specified parties.[9]

[*Signature*]

[*Date*]

Transportation Security Administration Security Fee

10.09 Following the terrorist attacks of September 11, 2001, Congress enacted the Aviation and Transportation Security Act, which established the Transportation Security Administration (TSA) as an administration within the Department of Transportation (DOT). The DOT issued rules in December 2001 imposing a security service fee in the amount of $2.50 per enplanement on passengers of domestic and foreign air transportation, and intrastate air transportation originating at airports in the United States. Collection of the security service fees began on air transportation sold on or after February 1, 2002, with monthly remittance of such fees. Pursuant to the rule, air carriers must establish an accounting system to properly track the amount of the security service fees imposed, collected, refunded, and remitted as well as the airports at which the passengers enplaned. Additionally, in the original rule, the TSA required an audit of the security service fee accounts and activities by an independent certified public accountant on an annual basis. The accountant must include in the audit opinion on whether (*a*) the air carrier's procedures for collecting, holding, and remitting the fees are fair and reasonable; and (*b*) whether the quarterly reports fairly represent the net transactions in the security service fee accounts. In September 2002, the TSA published a rule that it would not seek enforcement of the audit requirement as set forth previously, and currently, carriers are generally not requesting such audits.

[9] See footnote 5.

DOT Reporting

10.10 Although the Civil Aeronautics Board (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 is to conform its accounting requirements to U.S. generally accepted accounting principles.

10.11 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.

10.12 For reporting purposes, the financial statement presentation of an airline organization is similar to that of other commercial enterprises. The USAR provides for the grouping of revenues and expenses by both objective and functional activity and for varying detail information, depending on the accounting requirements and the capacities of the air carrier. Generally, the income statement presentation is divided among operating revenues, operating expenses, nonoperating income and expense (net), income taxes, and net income.

10.13 The functional classifications for revenues are basically divided among transport revenues and transport-related revenues. Transport revenues include all revenues for air transportation provided to all classes of traffic; they are broken into subclassifications for scheduled and nonscheduled services. Transport-related revenues result from services that are incidental to air transportation, such as liquor sales, sublease income, and maintenance work performed for other airlines.

10.14 The functional classifications for operating expenses are based on the type of activity or service rendered. Essentially, operating expense functions fall into eight major categories, represented by the following captions:

Classification	*Expenses Included*	*Major Items*
Flying operations	In-flight operations and holding of aircraft (except depreciation) and operational personnel in readiness for assignment to an in-flight status	Fuel, flight personnel (except flight attendants) payroll, employee benefits, and aircraft rentals
Maintenance	Direct and indirect expenditures for repair and maintenance	Labor, material, outside services, and general or overhead expense allocations
Passenger services	Expenditures relating to comfort, safety, and convenience in flight and during delays	Personnel and flight attendants' payroll and passenger food and supplies

Classification	*Expenses Included*	*Major Items*
Aircraft and traffic servicing	Compensation to ground personnel and other expenses incidental to the protection and control of in-flight aircraft movement, handling and servicing while in operation, scheduling and preparation of operational flight crews for assignment, and handling of ground property and equipment	Payroll costs and employee benefits, general services purchases, and servicing supplies, landing fees, and facility rentals
Reservations, sales, and advertising	Outlays to create a public preference for an air carrier, to stimulate the development of an air transportation market, or to develop air transportation in general	Passenger handling and traffic solicitations, payroll and benefits, travel agent commissions, and advertising
General and administrative	Expenditures of benefit to more than one operating function	Record-keeping and statistical personnel, federal excise and state taxes, and stationery supplies
Depreciation and amortization	Depreciation of operating property and equipment and amortization of intangible assets with finite useful lives	Depreciation of flight equipment, maintenance equipment, and ground property; amortization of airport gate leasehold rights, take-off and landing slots; and capitalized leases
Transport-related	Costs relating to generation of transport-related revenues	Liquor, maintenance for other carriers, and costs of subleases

DOT Form 41[10]

10.15 Information necessary to meet certain segment and geographical area disclosure requirements of Financial Accounting Standards Board *Accounting Standards Codification* 280, *Segment Reporting*, may, in some instances, be similar to that which airlines report to the DOT on Form 41. The

[10] The auditor does not have any responsibility with respect to financial information filed on Department of Transportation Form 41, but may read this form for informational purposes only. It is considered a best practice for airlines to reconcile the Form 41 data to their audited financial statements to identify differences in reporting classifications.

DOT currently requires air carriers to report earned revenues and related expenses by entities. These entities are defined as follows:

- Domestic operations
- Operations via the Atlantic Ocean
- Operations via the Pacific Ocean
- Operations within Latin American areas

10.16 The DOT definition of foreign operations is based on international flights rather than on whether a revenue-producing operation exists in that geographic area. A carrier with a flight to England has foreign revenue under the DOT definition, though it may not have operations in that country.

Revenues

10.17 Under the DOT definition, revenues are classified among the entities on the basis of a flight's origin and destination. The following exhibit illustrates this classification.

Classification of Foreign Operation Revenues		
Origin	*Destination*	*Entity*
Chicago	New York	Domestic
Chicago	London	Atlantic
Chicago	London (with stop in New York)	Allocate between domestic and Atlantic[11]
Chicago	Sao Paulo, Brazil	Latin America
London	Rome	Atlantic
London	Tokyo	Allocate between Atlantic and Pacific[12]
Tokyo	Chicago	Pacific

Expenses

10.18 Certain expenses, such as flight payroll and fuel, may be directly attributable to an entity and are, therefore, directly charged to that entity. Other expenses, such as aircraft depreciation and maintenance expense, are allocated to the entities through the use of ratios, such as plane miles flown by entity to total plane miles flown, revenue passenger miles by entity to total revenue passenger miles, or some other measure of the total effort expended to produce the revenue.

[11] The allocation of revenue between entities can be made by dividing the total fare on the basis of the ratio of plane miles flown, local fares, or some other logical method of splitting the fares.

[12] See footnote 11.

Appendix A

Mapping and Summarization of Changes—Clarified Auditing Standards

This appendix maps the extant[1] AU sections to the clarified AU-C sections. As a result of the Auditing Standards Board's (ASB's) Clarity Project, all extant AU sections have been modified. In some cases, individual AU sections have been revised into individual clarified standards. In other cases, some AU sections have been grouped together and revised as one or more clarified standards. In addition, the ASB revised the AU section number order established by Statement on Auditing Standards No. 1, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 110), to follow the same number order used in International Standards on Auditing (ISAs) for all clarified AU sections for which there are comparable ISAs. The clarified standards are effective for audits of financial statements for periods ending on or after December 15, 2012.

Although the Clarity Project was not intended to create additional requirements, some revisions have resulted in changes that may require auditors to make adjustments in their practices. To assist auditors in the transition process, these changes have been organized into the following four types:

- Substantive changes
- Primarily clarifying changes
- Primarily formatting changes
- Standards not yet issued in the Clarity Project

This appendix identifies those AU-C sections associated with these four types of changes.

Substantive Changes

Substantive changes are considered likely to affect the firms' audit methodology and engagements because they contain *substantive* or *other changes*, defined as having one or both of the following characteristics:

- A change or changes to an audit methodology that may require effort to implement
- A number of small changes that, although not individually significant, may affect audit engagements

Primarily Clarifying Changes

Primarily clarifying changes are intended to explicitly state what may have been implicit in the extant standards, which, over time, resulted in diversity in practice.

(continued)

[1] The term *extant* is used throughout this appendix in reference to the standards that are superseded by the clarified standards.

Primarily Formatting Changes

Primarily formatting changes from the extant standards do not contain changes that expand the extant sections in any significant way and may not require adjustments to current practice.

Standards Not Yet Issued in the Clarity Project

Standards not yet issued in the Clarity Project contain the remaining sections that are in exposure or have not yet been reworked.

The preface of this guide and the Financial Reporting Center at www.aicpa.org/frc provide more information about the Clarity Project. You can also visit www.aicpa.org/sasclarity.

Extant AU Sections Mapped to the Clarified AU-C Sections

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
110	Responsibilities and Functions of the Independent Auditor	All	200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards [1]	Primarily formatting changes
120	Defining Professional Requirements in Statements on Auditing Standards	All			
150	Generally Accepted Auditing Standards	All			
161	The Relationship of Generally Accepted Auditing Standards to Quality Control Standards	All	220	Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards	Primarily clarifying changes
201	Nature of the General Standards	All	200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards [1]	Primarily formatting changes
210	Training and Proficiency of the Independent Auditor	All			
220	Independence	All			
230	Due Professional Care in the Performance of Work	All			
311	Planning and Supervision	All except paragraphs .08–.10	300	Planning an Audit	Primarily formatting changes
		Paragraphs .08–.10	210	Terms of Engagement	Primarily clarifying changes

(continued)

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
312	Audit Risk and Materiality in Conducting an Audit	All	320	Materiality in Planning and Performing an Audit	Primarily formatting changes
			450	Evaluation of Misstatements Identified During the Audit	Primarily formatting changes
314	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	All	315	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	Primarily formatting changes
315	Communications Between Predecessor and Successor Auditors	All except paragraphs .03–.10 and .14	510	Opening Balances—Initial Audit Engagements, Including Reaudit Engagements	Primarily clarifying changes
		Paragraphs .03–.10 and .14	210	Terms of Engagement	Primarily clarifying changes
316	Consideration of Fraud in a Financial Statement Audit	All	240	Consideration of Fraud in a Financial Statement Audit	Primarily formatting changes
317	Illegal Acts by Clients	All	250	Consideration of Laws and Regulations in an Audit of Financial Statements	Substantive changes
318	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained	All	330	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained	Primarily formatting changes

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
322	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	All	Planned to be issued as AU-C section 610	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	Standards not yet issued in the Clarity Project
324	Service Organizations	All	402	Audit Considerations Relating to an Entity Using a Service Organization	Primarily clarifying changes
325	Communicating Internal Control Related Matters Identified in an Audit	All	265	Communicating Internal Control Related Matters Identified in an Audit	Substantive changes
326	Audit Evidence	All	500	Audit Evidence	Primarily formatting changes
328	Auditing Fair Value Measurements and Disclosures	All	540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures [2]	Primarily formatting changes
329	Analytical Procedures	All	520	Analytical Procedures	Primarily formatting changes
330	The Confirmation Process	All	505	External Confirmations	Primarily clarifying changes
331	Inventories	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes
332	Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes

(continued)

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
333	Management Representations	All	580	Written Representations	Primarily formatting changes
334	Related Parties	All	550	Related Parties	Substantive changes
336	Using the Work of a Specialist	All	620	Using the Work of an Auditor's Specialist	Primarily Clarifying Changes
337	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes
339	Audit Documentation	All	230	Audit Documentation	Primarily formatting changes
341	The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern	All	570	The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern	Primarily formatting changes
342	Auditing Accounting Estimates	All	540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures [2]	Primarily formatting changes
350	Audit Sampling	All	530	Audit Sampling	Primarily formatting changes
380	The Auditor's Communication With Those Charged With Governance	All	260	The Auditor's Communication With Those Charged With Governance	Primarily formatting changes
390	Consideration of Omitted Procedures After the Report Date	All	585	Consideration of Omitted Procedures After the Report Release Date	Primarily formatting changes

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
410	Adherence to Generally Accepted Accounting Principles	All	700	Forming an Opinion and Reporting on Financial Statements [4]	Substantive changes
420	Consistency of Application of Generally Accepted Accounting Principles	All	708	Consistency of Financial Statements	Primarily clarifying changes
431	Adequacy of Disclosure in Financial Statements	All	705	Modifications to the Opinion in the Independent Auditor's Report [5]	Primarily formatting changes
504	Association With Financial Statements	All	N/A	Withdrawn	

(continued)

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
508	Reports on Audited Financial Statements	Paragraphs .01–.11, .14–.15, .19–.32, .35–.52, .58–.70, and .74–.76	700	Forming an Opinion and Reporting on Financial Statements [4]	Substantive changes
			705	Modifications to the Opinion in the Independent Auditor's Report [5]	Primarily formatting changes
			706	Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report [6]	Substantive changes
		Paragraphs .12–.13	600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)	Substantive changes
		Paragraphs .16–.18 and .53–.57	708	Consistency of Financial Statements	Primarily clarifying changes
		Paragraphs .33–.34	805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement	Primarily clarifying changes
		Paragraphs .71–.73	560	Subsequent Events and Subsequently Discovered Facts [7]	Primarily formatting changes

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
530	Dating of the Independent Auditor's Report	Paragraphs .01–.02	700	Forming an Opinion and Reporting on Financial Statements [4]	Substantive changes
		Paragraphs .03–.08	560	Subsequent Events and Subsequently Discovered Facts [7]	Primarily formatting changes
532	Restricting the Use of an Auditor's Report	All	905	Alert That Restricts the Use of the Auditor's Written Communication	Primarily clarifying changes
534	Reporting on Financial Statements Prepared for Use in Other Countries	All	910	Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country	Primarily clarifying changes
543	Part of Audit Performed by Other Independent Auditors	All	600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)	Substantive changes
544	Lack of Conformity With Generally Accepted Accounting Principles	All	800	Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks [8]	Primarily clarifying changes
550	Other Information in Documents Containing Audited Financial Statements	All	720	Other Information in Documents Containing Audited Financial Statements	Primarily formatting changes

(continued)

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
551	Supplementary Information in Relation to the Financial Statements as a Whole	All	725	Supplementary Information in Relation to the Financial Statements as a Whole	Primarily formatting changes
552	Reporting on Condensed Financial Statements and Selected Financial Data	All	810	Engagements to Report on Summary Financial Statements	Primarily clarifying changes
558	Required Supplementary Information	All	730	Required Supplementary Information	Primarily formatting changes
560	Subsequent Events	All	560	Subsequent Events and Subsequently Discovered Facts [7]	Primarily formatting changes
561	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	All			

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
623	Special Reports	Paragraphs .19–.21	806	Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements	Primarily formatting changes
		Paragraphs .01–.10 and .22–.34	800	Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks [8]	Primarily clarifying changes
		Paragraphs .11–.18	805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement	Primarily clarifying changes
625	Reports on the Application of Accounting Principles	All	915	Reports on Application of Requirements of an Applicable Financial Reporting Framework	Primarily formatting changes
634	Letters for Underwriters and Certain Other Requesting Parties	All	920	Letters for Underwriters and Certain Other Requesting Parties	Primarily formatting changes
711	Filings Under Federal Securities Statutes	All	925	Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933	Primarily formatting changes

(continued)

Extant AU Sections Mapped to the Clarified AU-C Sections—*continued*

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
722	Interim Financial Information	All	930	Interim Financial Information	Primarily formatting changes
801	Compliance Audits	All	935	Compliance Audits	Primarily formatting changes
901	Public Warehouses—Controls and Auditing Procedures for Goods Held	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes

Legend:

[n] Bracketed number indicates a clarity standard that supersedes more than one extant AU section.

The AICPA has developed an Audit Risk Alert to assist auditors and members in practice prepare for the transition to the clarified standards. It has been organized to give you the background information on the development of the clarified standards and to identify the new requirements and changes from the extant standards. Check out the Audit Risk Alert *Understanding the Clarified Auditing Standards* (product no. ARACLA12P, ARACLA12E, and ARACLA12O), which is available in the AICPA store on www.cpa2biz.com.

Appendix B

International Financial Reporting Standards

> ***Note:*** The following content may include certain changes made since the original print version of the guide.

Introduction

The following information provides a brief overview of the ongoing globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that accounting principles generally accepted in the United States of America (U.S. GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing pressure to globalize accounting standards, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. More than 100 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies and most have fully conformed to IFRSs as promulgated by the International Accounting Standards Board (IASB) and include a statement acknowledging such conformity in audit reports. Several countries, including Argentina and Canada, adopted IFRSs on January 1, 2011, and many other countries have plans to converge (or eliminate significant differences between) their national standards and IFRSs in the future.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with IFRSs as issued by the IASB. In addition, the SEC continues to analyze and evaluate appropriate steps toward, and challenges related to, incorporating IFRSs into the U.S. financial reporting system, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost reductions are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Substantial internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.

Who is the IASB?

The IASB is the independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. As a private sector organization, the IFRS Foundation has no authority to impose funding regimes on countries. However, a levy system and national contributions through regulatory and standard-setting authorities or stock exchanges have been introduced in a number of countries to fund the organization. Although the AICPA was a founding member of the International Accounting Standards Committee, the IASB's predecessor organization, it is not affiliated with the IASB.

The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (*a*) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (*b*) the IFRS Advisory Council; and (*c*) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IFRS Foundation is linked to a monitoring board of public authorities, including committees of the International Organization of Securities Commissions, the European Commission, and the SEC. The monitoring board's main responsibilities are to ensure that the trustees continue to discharge their duties as defined by the IFRS Foundation Constitution, as well as approving the appointment or reappointment of trustees. In addition, through the monitoring board, capital markets authorities that allow or require the use of IFRSs in their jurisdictions will be able to more effectively carry out their mandates regarding investor protection, market integrity, and capital formation.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The IASB has members from several different countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities* (*IFRS for SMEs*), and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

1. Standards, whether labeled IFRSs or International Accounting Standards (IASs)[1]
2. Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)[2]

The preface to the IFRS *2012 Bound Volume* states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to apply to not-for-profit entities or those in the public sector,[3] but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Conceptual Framework for Financial Reporting* (conceptual framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IASB is guided by the conceptual framework in the development of future standards and in its review of existing standards. The conceptual framework is not an IFRS, and when there is a conflict between the conceptual framework and any IFRS, the standard will prevail. The conceptual framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (*a*) represent faithfully the financial position, financial performance, and cash flows of the entity; (*b*) reflect the economic substance of transactions, other events, and conditions; (*c*) are neutral; (*d*) are prudent; and (*e*) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

1. The requirements and guidance in IFRSs dealing with similar and related issues

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[1] See www.ifrs.org for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

[2] See www.ifrs.org for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

[3] Generally speaking, *public* means government-owned entities, and *private* means nongovernment-owned entities.

2. The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the conceptual framework

Management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework (for example, U.S. GAAP), other accounting literature, and accepted industry practices to the extent that these do not conflict with IFRSs.

IFRS for SMEs

IFRS for SMEs is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

SMEs are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs.*

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of generally accepted accounting principles.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*.[4]

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at http://wiki.ifrs.com/.

The Financial Accounting Standards Board and IASB Convergence Efforts[5]

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a "Memorandum of Understanding" (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company's transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential for different interpretations of similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is

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[4] CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

[5] Because the convergence projects discussed are active and subject to change, updates will be posted periodically to www.journalofaccountancy.com. Readers also are encouraged to monitor the progress of these projects at the respective boards' websites: www.ifrs.org and www.fasb.org.

decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company's industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.
- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for example, IAS 41, *Agriculture*)[6] that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

SEC Work Plan

The SEC continues to affirm its support for a single set of high-quality, globally accepted accounting standards; however, no decision has been made on whether or not to adopt IFRSs. In May 2011, the SEC staff produced a work plan outlining how such a possible transition might happen.

In November 2011, the SEC released a staff paper that summarizes the current status of convergence projects, which are grouped by both short-term and

[6] In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

long-term, as well as by level of priority (greater priority versus lower priority). Currently, the three projects that are of greater priority are financial instruments, revenue recognition, and leases.

In July 2012, the SEC published its final staff report on the Work Plan, which focuses on the arguments for and against various forms of adoption of global accounting standards. When assessing the implications of incorporating IFRSs in the U.S. financial reporting system, the SEC concluded that while international standards have improved in comprehensiveness, there are still some gaps, especially in the areas of insurance, extractive industries, and rate-regulated industries. The report also states that the costs of full IFRS adoption remain to be among the most significant costs required from an accounting perspective, and that companies questioned whether the benefits would justify such a full-scale transition. Although the report does not contain information leading to any decision the SEC has made regarding incorporation of IFRSs, the staff expects that the SEC and others in the United States will remain involved with the development and application of IFRSs.

Refer to www.sec.gov for the full version of the staff paper.

AICPA

In response to an SEC staff paper issued in May 2011, the AICPA issued a comment letter in August 2011 stating AICPA's agreement with the SEC that FASB should continue to have an active role in the international financial reporting arena to ensure that U.S. interests are suitably addressed in the development of IFRSs. Results from an IFRS Readiness Survey conducted by the AICPA in September 2011 show that a majority of CPAs support optional adoption of IFRSs. This would allow publicly traded U.S. companies to use IFRS while the SEC decides whether to incorporate the standards into U.S. reporting requirements. In response to the SEC's final staff report on the Work Plan, the AICPA applauds the SEC's efforts in performing a detailed review of IFRSs and stresses the importance of high-quality, transparent, and comparable financial information for the world's capital markets to make sound investment decisions.

Additional Resources

Website	***URL***
AICPA	www.aicpa.org
AICPA International Financial Reporting Standards Resources	www.ifrs.com
International Accounting Standards Board and IFRS Foundation	www.ifrs.org
Comparison Wiki of *International Financial Reporting Standard for Small- and Medium-sized Entities* and U.S. generally accepted accounting principles	http://wiki.ifrs.com
Financial Accounting Standards Board	www.fasb.org

Appendix C

Schedule of Changes Made to the Text From the Previous Edition

As of March 1, 2013

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Reference	*Change*
General	Guidance related to the clarified auditing standards (SAS Nos. 122–127 [AICPA, *Professional Standards*]) has been incorporated throughout this guide. See appendix A, "Mapping and Summarization of Changes–Clarified Auditing Standards," for a mapping of the extant standards to the clarified AU-C sections.
Preface	Revised for the passage of time.
Paragraph 1.07	Revised for clarity.
Paragraph 1.09	Revised for the passage of time.
Paragraphs 1.17, 1.29, 1.37–.38, and 1.68	Revised for clarity.
Paragraph 2.05	Revised for the passage of time.
Paragraph 2.10	Revised for clarity.
Paragraph 2.29	Revised for the passage of time.
Paragraph 2.49	Revised for clarity.
Former footnote * to the heading before paragraph 2.57	Deleted for the passage of time.
Paragraph 2.57	Revised for the passage of time.
Former footnote * to the heading before paragraph 2.136	Deleted for the passage of time.

(continued)

Reference	*Change*
Footnote 1 in chapter 3 title	Revised to reflect the issuance of Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.
Paragraphs 3.41 and 3.46	Revised for clarity.
Footnote 2 in paragraph 3.49	Revised for the passage of time.
Paragraph 3.52	Revised for the passage of time.
Paragraph 3.97	Revised for clarity.
Paragraph 3.106	Revised for the passage of time.
Paragraphs 3.113–.114	Revised for clarity.
Paragraph 3.121	Revised for the passage of time.
Former footnote † in paragraph 3.121	Deleted for the passage of time.
Paragraph 3.122	Revised for the passage of time.
Paragraph 3.140	Revised for clarity.
Paragraph 4.09	Revised for clarity.
Paragraph 4.28	Added for clarity.
Paragraphs 4.36 and 4.43	Revised for clarity.
Former footnotes * and † to the heading before paragraph 4.61	Deleted for the passage of time.
Paragraph 4.61	Revised to reflect the issuance of ASU No. 2011-04.
Paragraphs 4.68, 4.75, 4.79–.80, 4.106, 4.113, and 4.126	Revised for clarity.
Former footnote * in paragraph 5.06	Deleted for the passage of time.
Former footnote * in paragraph 6.10	Deleted for the passage of time.
Paragraph 6.10	Revised for the passage of time.
Paragraphs 6.32, 6.34, and 6.43	Revised for clarity.
Paragraphs 6.44–.48	Added to reflect the issuance of FASB ASU No. 2012-02, *Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*.

Reference	*Change*
Paragraphs 6.49–.50	Revised to reflect the issuance of ASU No. 2012-02.
Paragraph 6.95	Revised for clarity.
Paragraph 8.04	Revised for clarity.
Footnote 1 to the heading before paragraph 8.08	Revised for the passage of time.
Former footnote † to the heading before paragraph 8.26	Deleted for the passage of time.
Former footnote * to the heading before paragraph 9.05	Deleted for the passage of time.
Former footnote † to the heading before paragraph 9.28	Deleted for the passage of time.
Paragraph 9.42	Revised to reflect the passage of time.
Paragraph 9.64	Revised for clarity.
Paragraph 10.04	Revised for the passage of time.
Appendix A	Added.
Appendix B	Revised for the passage of time.
Index of Pronouncements and Other Technical Guidance	Added.
Subject Index	Updated.

Glossary

The following terms can be found in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary:

airbill. The nonnegotiable shipping document used by domestic air carriers as evidence of an air freight shipment. The document contains shipping instructions, commodity descriptions, and transportation charges applicable to the freight shipped. Sometimes the term is used interchangeably with *air waybill*; however, these terms are correctly synonymous only when the domestic airbill meets the uniformity requirements of the air waybill set by the Warsaw Convention.

air cargo. In the United States, the total volume of freight, mail, and express traffic that is transported by air. U.S. air cargo consists of the following classes of service: priority mail (airmail and air parcel post), nonpriority mail (airlift of first-class mail on a space available basis), foreign mail (mail destined to or from foreign countries), air express (priority movement of packages, generally under 50 pounds), and air freight (the airlift of commodities of all kinds).

air carrier. An entity that undertakes, whether directly or indirectly or by a lease or any other arrangement, to engage in air transportation.

airframe. The structure of an aircraft, excluding engines and accessories. The principal parts of the airframe of an airplane include the fuselage (the body), wings, empennage (the assembly of stabilizing and control surfaces at the tail), landing gear, and nacelles or pods (engine housings).

airframe modifications. Modifications made to interior configurations of aircraft types—including the reconfiguration and replacement of seats, galley equipment, and storage space (further industry-specific information provided in the following list of terms).

airworthiness. The ability of a particular aircraft or component part to perform its function satisfactorily through a range of operations determined by the Federal Aviation Administration (FAA).

coupon. The term coupon is often used to collectively refer to lifted flight coupons and other electronic evidence of boarding, in which case, it is applicable to both paper tickets and electronic tickets (further industry-specific information provided in the following list of terms).

developmental costs. 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.

electronic ticket (e-ticket). An e-ticket reflects the passenger's itinerary in electronic form. Like paper tickets, e-tickets contain information for each flight segment of a passenger's itinerary. However, while a paper ticket consists of multiple coupons that are used to record a sale and to document the service rendered, e-tickets exist only as a digital record in the airline computer system and contain no paper coupons. The airline's host reservation system or global distribution system (GDS) produces an e-ticket sales record for each sale transaction, which is used to record a sale of e-ticket. Boarding documents are issued for e-tickets at check-in,

Audit and Accounting Guide: Airlines, First Edition. AICPA.

and the carrier documents transportation service at the boarding point by either collecting boarding documents or scanning them as evidence of the service rendered (further industry-specific information provided in the following list of terms).

expendable parts. Parts that are ordinarily used up (consumed) and replaced with new parts as opposed to those parts that are capable of being used over and over after being refurbished (rotable flight equipment) (further industry-specific information provided in the following list of terms).

fare. The amount per passenger or group of persons stated in the applicable tariff for the transportation, including baggage, unless otherwise specified.

lifted flight coupon. The coupon that is detached from the airline ticket book by the carrier providing the transportation service at the boarding point as evidence of the service rendered (further industry-specific information provided in the following list of terms). See **coupon**, **paper ticket**, and **electronic ticket**.

on-line lifts. On-line lifts occur when the lifted flight coupon for transportation service is received by the same airline that sold the flight coupon.

on-line sale and off-line sale. A ticket sold by an airline and ultimately used on that airline is referred to as an on-line sale; a ticket sold by one airline and used on another airline is referred to as an off-line sale. One ticket can include several flight segments and, also, can include flights on various carriers.

paper ticket. A printed document that serves as evidence of payment of the fare for air transportation. It authorizes carriage between the points and via the routing indicated and also shows the passenger's name, class of service, carrier(s), flight number(s), dates of travel, and all conditions of the contract of carriage. Generally, this takes the form of the standard Air Traffic Conference ticket, which is composed of an auditor's coupon, agent's coupon, flight coupon(s), and passenger's coupon. The auditor's coupon is the initial document used to record a sale. Flight coupons represent each flight segment (leg) of the passenger's itinerary. Flight coupons are lifted (detached from the ticket booklet) by the carrier providing the transportation service at the boarding point as evidence of the service rendered, although today this process is entirely electronic for the vast majority of ticket sales and boarding transactions (further industry-specific information provided in the following list of terms). See **coupon**, **lifted flight coupon**, and **electronic ticket**.

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

revenue passenger mile (RPM). One fare-paying passenger transported one mile. Revenue passenger miles are computed by multiplying the number of revenue passengers by the miles that they are flown.

rotable parts. Rotable parts normally repaired and reused, as opposed to those parts that are consumed in the operations (expendable parts); (further industry-specific information provided in the following list of terms). See **expendable parts** and **repairable parts**.

The following is a list of additional terms that have been used in this guide and further information on select terms defined in the FASB ASC glossary:

aircraft, crew, maintenance, and insurance (ACMI) contract. Contracts under which air cargo carriers provide aircraft, crew, maintenance, and insurance services for other airlines. Under an ACMI contract, customers receive dedicated aircraft capacity in exchange for a guaranteed minimum level of operation. ACMI contracts typically require customers to guarantee minimum aircraft utilization levels at fixed hourly rates and may be in effect for periods that can range from a day to up to five years.

aircraft miles flown. The miles (computed in airport-to-airport distances) for each flight stage actually completed, regardless of whether it was performed in accordance with the scheduled pattern. For this purpose, operation to a flag stop is a stage completed, even though a landing is not actually made. In cases in which the interairport distances are inapplicable, aircraft miles flown are determined by multiplying the normal cruising speed for the aircraft type by the airborne hours.

aircraft servicing expense. Compensation of ground personnel and other expenses incurred on the ground incident to the protection and control of the in-flight movement of the aircraft; scheduling or preparation of aircraft operational crews for flight assignment; landing and parking of aircraft; visual inspection; routing, checking, servicing, and fueling of aircraft; and other expenses incurred on the ground incident to readying for aircraft arrival and takeoff.

airframe modifications. Modifications made to interior configurations of aircraft types—including the reconfiguration and replacement of seats, galley equipment, and storage space—typically in response to market forces and passenger demands, as well as modifications arising from airworthiness directives (defined in the FASB ASC glossary, as presented in the first section of this glossary). See **airworthiness directives**.

airport operating rights. These rights represent the value inherent in a carrier's established operations at certain airports. Generally, this intangible asset exists at airports which have some or all of the following characteristics: significant barriers to entry exist at the airport, the airport is capacity constrained, or an airline has a substantial portion of the airport's capacity. An example would be an airline's operations at either its hub location or at a high-density, capacity-constrained airport that is not slot controlled.

air traffic liability (ATL). The value of air transportation services sold but as yet unused by the passenger, including sales for air transportation to be provided by the reporting air carrier and air transportation to be provided by another air carrier for whom sales were made. This is sometimes referred to as *unearned transportation revenue*.

air traffic liability (ATL) breakage. Recorded ticket sales that remain partially or wholly unused after either the scheduled departure date or ticket expiration date. Historically, ATL breakage has included both the revenue breakage and invalid tickets. See **revenue breakage** and **invalid ticket**.

airworthiness directives. Airworthiness directives are issued by the FAA and require the airline to perform modifications or additional inspections and checks or install additional equipment on existing aircraft. See **airworthiness**.

allowance for obsolescence. An allowance for obsolescence is established by airlines to distribute the cost of expendable spare parts expected to be on hand at the end of a fleet's life over the service lives of the related equipment. Typically, the spare parts obsolescence provision for the period is calculated by taking the historical cost of the spare parts; reducing it by the estimated base stock, the estimated salvage value, and the current allowance for obsolescence; and then dividing the remaining amount by the remaining useful or average service life of the aircraft to which the parts relate.

amendable labor contracts. Collective bargaining agreements that under the provisions of the Railway Labor Act of 1926 (RLA), which governs the labor relations of employers and employees engaged in the airline industry, do not expire but rather become amendable as of a stated date. Comprehensive provisions are set forth in the RLA establishing the right of airline employees to organize and bargain collectively along craft or class lines and imposing a duty upon air carriers and their employees to exert every reasonable effort to make and maintain collective bargaining agreements. The RLA contains detailed procedures that must be exhausted before a lawful work stoppage may occur. Under the RLA, an amendable labor contract continues in effect while the parties negotiate a new contract.

auditor's coupon. The initial document used to record the sale of a paper ticket. See **paper ticket**.

available seat miles (ASMs). The aircraft miles flown on each flight segment multiplied by the number of seats available for revenue use on that segment.

available seats. Installed seats in an aircraft (including seats in lounges), exclusive of any seats not offered for sale to the public by the carrier, provided that in no instance shall any seat sold be excluded from the count of available seats.

available ton miles (ATMs). The aircraft miles flown on each flight segment multiplied by the number of tons available for the transportation of passengers, freight, mail, and express for revenue use on that segment.

average aircraft utilization. Ratio of time the aircraft is used divided by the time the aircraft is available. It is expressed in hours per day.

average flight segment length. The average distance in statute miles covered by an aircraft in revenue service from takeoff to landing.

beyond flying capability (also referred to as *beyond right*). The right to fly beyond the territory of the party to a bilateral aviation agreement to a third country, either with or without the right to take on passengers and cargo in the partner's country.

block-to-block aircraft hours. The hours from the moment an aircraft first moves under its own power (including taxi time before takeoff and after landing) for purposes of flight until it comes to rest at the next point of landing. This term is sometimes referred to as *ramp-to-ramp aircraft hours.*

break-even load factor. The load factor in scheduled revenue service that is required for scheduled passenger revenue less passenger traffic expense to equal passenger capacity expense. The split into types of cost is not strictly *fixed* versus *variable* costs as those terms are used in accounting literature. See **traffic expense** and **capacity expense**.

built-in overhaul. The portion of the cost of flight equipment that represents the estimated cost of the initial overhaul of the flight equipment.

buyer-furnished equipment (BFE). Interior parts of the aircraft provided by the airlines purchasing the aircraft to the aircraft manufacturer for use in the assembly process. BFE typically includes seats, galleys, overhead bins, in-flight entertainment systems, and other equipment that the airline uses to provide customer service.

capacity purchase agreement. Contracts under which the major carrier "purchases" the use of the regional airline's aircraft and flight crews and other related services. The aircraft is painted in the colors and logos of the major airline, and the major airline also takes responsibility for aircraft scheduling, ticket pricing, reservations, collections, and marketing. Ground handling of the aircraft may be performed by either the major carrier or the regional airline. See **fee-per-departure contract** and **cost-based contract**.

capacity expense. Expense related to the provision of available aircraft capacity, regardless of the degree to which that capacity is utilized.

cargo ton mile (CTM). One ton of cargo (freight, express, and mail) transported one mile.

code-sharing. A practice where a flight operated by an airline is jointly marketed as a flight for one or more other airlines. Under a code-sharing agreement, participating airlines can present a common flight number or use different flight numbers. The airline that actually operates the flight is called the *operating carrier*. The airline or airlines that sell tickets for that flight but do not actually operate it are called marketing carriers. Such alliances also usually tie in each airline's marketing and frequent flyer programs and provide for schedule coordination for convenient connections between airlines.

cost-based contract. A form of the capacity purchase agreement between a major airline and a regional airline under which the regional carrier is compensated based on specific costs it incurs plus a margin. Typically, under cost-based contracts, the regional carrier's revenue consists of three elements: (1) reimbursement of costs over which the regional carrier has control, which is based on a fixed rate applied to some measure of operations (for example, flight hours, passengers carried, cycles, or block hours); (2) reimbursement of costs over which the regional carrier typically has no control, which is done on an actual or pass-through cost basis; and (3) a profit or margin component. See **capacity purchase agreement** and **fee-per-departure contract**.

coupon. Coupon is a component of a paper ticket (see **paper ticket**, **flight coupon**, **lifted flight coupon**, and **auditor's coupon**). The term *coupon* is also used to refer to the value associated with each individual flight segment, which can be evidenced by lifted flight coupons and other electronic evidence of boarding the individual flight segment, in which case, it is applicable to both paper and electronic tickets (defined in the FASB ASC glossary, as presented in the first section of this glossary). See **electronic ticket**, **online ticket/coupon**, and **offline ticket/coupon**.

deplaned traffic. A count of the number of passengers exiting and tons of cargo being unloaded from an aircraft. For this purpose, passengers and cargo on aircraft leaving a carrier's system on interchange flights are considered to be deplaning at the interchange point; passengers and cargo moving from one operation to another operation of the same carrier, for which separate reports are required by the Department of Transportation (DOT), are considered to be deplaning at the junction point.

depressant. Depressant is used to simplify the calculations involved in interline billing process. The depressant is based on a historical ratio of standard local fares to settled fares and is used to adjust the current month's interline billings.

electronic ticket (e-ticket). An e-ticket reflects the passenger's itinerary in electronic form. Like paper tickets, e-tickets contain information for each flight segment of a passenger's itinerary. However, while a paper ticket consists of multiple coupons that are used to record a sale and to document the service rendered, e-tickets exist only as a digital record in the airline computer system and contain no paper coupons. (Please note that in practice and in this guide, the term *coupon* is often used to collectively refer to lifted flight coupons and other electronic evidence of boarding, in which case, it is applicable to both paper and electronic tickets.) Instead, the airline's host reservation system or GDS produces an e-ticket sales record for each sale transaction, which is used to record a sale of e-ticket. Boarding documents are issued for e-tickets at check-in, and the carrier documents transportation service at the boarding point by either collecting boarding documents or scanning them as evidence of the service rendered (defined in the FASB ASC glossary, as presented in the first section of this glossary). See **coupon**, **lifted flight coupon**, and **paper ticket**.

enhanced equipment trust certificate (EETC). Leasing structure used by airlines to finance aircraft acquisitions. These structures are initially the same as equipment trust certificates, except that additional series of trusts are involved to modify the cash flows in order to provide for a number of credit ratings to improve the overall creditworthiness of the debt securities issued by the equipment trust. Depending on how the third-party investment is structured, EETCs generally result in either debt or an operating lease from the airline's perspective. See **equipment trust certificate**.

enplaned traffic. A count of the number of passengers boarding and tons of cargo being loaded on an aircraft. For this purpose, passengers and cargo on aircraft entering a carrier's system on interchange flights are considered to be enplaning at the interchange point; passengers and cargo moving from one operation to another operation of the same carrier, for which separate reports are required by the DOT, are considered to be enplaning at the junction point.

equipment trust certificate (ETC). Leasing structure used by airlines to finance aircraft acquisitions. Typically in these transactions, the aircraft is placed in a trust with an equity participant (other than the airline) and then the trust issues debt to public or private parties to fund the remainder of the acquisition of the aircraft, which is then leased back to the airline (alternatively, the agreement between the trust and the airline can be structured as debt). See **enhanced equipment trust certificate**.

expendable parts. Parts that cannot be economically repaired, reconditioned, or reused after removal from the aircraft (defined in the FASB ASC glossary, as presented in the first section of this glossary). See **repairable parts** and **rotable parts**.

fee-per-departure contract. A form of the capacity purchase agreement between a major airline and a regional airline under which the regional carrier is compensated based on a rate per departure. The rate is intended to cover all of the costs and a profit margin for operation of the specified flight. This rate is generally either a per-departure amount (for a specified origin and destination) or an amount per block hour of operation. See **capacity purchase agreement** and **cost-based contract**.

fifth freedom right. The right to enplane traffic at one foreign point and deplane it in another foreign point as part of the continuous operation also serving the airline's homeland.

flag stop. A point on an air carrier's predetermined route that is scheduled to be served only when traffic is to be picked up or discharged.

flight coupon. A coupon in a paper ticket issued for transportation that contains the itinerary of the passenger(s) but is valid only for carriage between the passenger's point of enplanement and deplanement on a single flight, as noted on the coupon. It also includes the class of service, stopover code, carrier, date of travel, flight number, and applicable fee. See **coupon**, **lifted flight coupon**, **paper ticket**, and **electronic ticket**.

flight equipment. Airframe, aircraft engines, aircraft propellers, aircraft communications and navigational equipment, miscellaneous equipment used in the operation of the aircraft, and improvements to leased flight equipment.

flight leg. See **flight segment**.

flight segment. A flight segment is defined as a takeoff and a landing. It is a segment of a flight involving a stopover, change of aircraft, or change of airline. It is also referred to as *flight leg*.

frequent flyer programs (FFPs). Programs used by airlines to encourage passenger loyalty by providing rewards geared to the frequency of travel on the sponsoring airline, typically in the form of frequent flyer miles, points, or segments that can be accumulated and converted into free or discounted travel.

gate. A section at an airport terminal for transferring passengers and airline crews to an aircraft. This intangible asset represents the right to use a gate. A gate is generally recorded as a separate asset if the right to use the gate is acquired from another airline.

interline airlines. Airlines that have agreed to provide transportation interchangeably with other carriers. See **noninterline airlines** and **interline ticketing.**

interline ticketing (also known as *interlining*). A commercial agreement between individual airlines to handle passengers traveling on itineraries that require multiple airlines. Interlining agreements are voluntary. Low-cost carrier airlines that only sell directly to consumers (and not through agencies or GDS systems) typically do not support interlining at all. If no interline ticketing agreement exists, separate tickets will need to be issued, and passengers will have to retrieve their checked-in luggage and carry it to the connecting airline for check-in. Interlining agreements differ from code-sharing agreements in that code-sharing agreements usually refer to numbering a flight with the airline's code even though the flight is operated by another airline. However, code-share relationships can affect whether an interline ticket can be issued. Both the code-share marketing carrier and code-share operating carrier must have interline agreements with all other carriers in the itinerary to allow a single ticket to be issued. See **code-sharing**.

international route authority. A right to operate flights to foreign markets. Route certificates are awarded by the U.S. government to individual U.S. registered carriers on a temporary basis and can be renewed upon expiration by the DOT.

invalid ticket. A ticket that has lost its value. It generally occurs at departure date or, in certain circumstances, at some point subsequent to departure date but prior to its contractual expiration date. See **valid ticket**.

joint fare. A fare, published as a single factor, that applies to transportation over the joint lines or routes of two or more carriers and is made and published by arrangements or agreement among the carriers, evidenced by concurrence or power of attorney. See **local fare**.

landing fees. Fees paid to an airport or other governmental authority for each aircraft landing. Usually, the fees are levied on the weight of the aircraft that has landed.

load factor. The percentage of revenue passenger miles to available seat miles in revenue passenger service, representing the proportion of aircraft seating capacity that is actually utilized. For cargo, the term refers to the percentage of cargo revenue ton miles to available cargo ton miles.

local fare. A fare that applies to transportation over the lines or routes of one carrier only. See **joint fare**.

marketing carrier. The airline or airlines that participate in code-sharing agreements and sell tickets for the flight but do not actually operate it. See **operating carrier**.

noninterline airlines. Airlines that only issue tickets that may be used for transportation on the airline's own flights and provide transportation only to passengers holding tickets issued by the airline. See **interline airlines** and **interline ticketing**.

nonrevenue traffic. Passengers and cargo transported by air for which no remuneration or token service charges are received by the air carrier. Airline employees, passengers redeeming their FFP awards, officers, directors, or other persons, except for ministers of religion, who are traveling under reduced-rate transportation authorized by Section 403(b) of the Federal Aviation Act and part 223 of the board's economic regulations. Travel agents, cargo agents, and tour conductors traveling at reduced fares are also considered nonrevenue traffic. See **revenue traffic**.

offline (OAL) carrier. Carrier on which transportation is scheduled but which did not sell the ticket. See **online (OL) carrier**.

offline or other airline (OAL) sale. A ticket sold by one airline that includes flight segments to be traveled on another airline. See **online (OL) sale**.

offline (OAL) ticket/coupon. Tickets sold by other airlines and used by passengers on the operating carrier. See **online (OL) ticket/coupon**.

online (OL) carrier. Carrier that issues the ticket and collects the total fare from the passenger. The OL carrier then settles the fare with the other carriers on which transportation is scheduled, known as OAL carriers, on the basis of interline agreements. See **offline (OAL) carrier**.

online (OL) sale. A ticket sold by an airline in which transportation on all flight segments will be provided only by that airline. See **offline (OAL) sale**.

online (OL) ticket/coupon. Tickets sold by the carrier providing transportation and used by the passenger on that airline. See **offline (OAL) ticket/coupon**.

operating carrier. The airline that actually operates the flight. It provides the plane, the crew, and the ground handling services. See **marketing carrier**.

oversale (overbooking). The sale of (or, in the case of overbooking, the acceptance of reservations for) more space (passenger seats) than is actually available on a flight. A practice that is used sometimes by the air carriers as an allowance for that historical percentage of passengers who fail, for some reason, to use the space they have reserved on a flight. In those cases in which the actual number of passengers with purchased tickets exceeds the available space for a flight, the carrier is liable for denied boarding compensation to those passengers not accommodated on the flight or on comparable air transportation.

passenger facility charges (PFC). The PFC Program allows the collection of PFC fees for every enplaned passenger at commercial airports controlled by public agencies. Airports use these fees to fund FAA-approved projects that enhance safety, security, or capacity; reduce noise; or increase air carrier competition.

passenger mile. One passenger transported one mile. Passenger miles are computed by multiplying the aircraft miles flown on each flight stage by the number of passengers transported on that stage.

power-by-the-hour (PBTH) contract. An arrangement for outsourcing scheduled maintenance activities. These contracts generally provide that, in exchange for a payment of a fixed amount per flight hour or other applicable unit of measurement associated with the aircraft (for example, block hours or cycles), the maintenance provider will provide specified maintenance activities associated with a particular aircraft for a specified period. See **time-and-material contract**.

prorate agreement. See **proration**.

proration. Method of dividing the total fare among the concerned carriers according to the joint fares published in the Industry Prorate Manual or in accordance with existing agreements between the airline partners, which are frequently referred to as *special prorate agreements*. Interline, codesharing, and alliance agreements, as well as some contracts between major and regional airlines, typically use proration to allocate revenue among the airlines.

ramp-to-ramp aircraft hours. See **block-to-block aircraft hours**.

rate. The amount per unit stated in the applicable tariff for the transportation of property.

repairable parts. Parts that are repairable and reusable but with economic useful lives generally less than the aircraft they support and values less than most rotable parts. See **expendable parts** and **rotable parts**.

retroactive wages. A provision that may be included in a newly negotiated collective bargaining agreement that calls for payments to airline employees to compensate them for services provided during the period between the amendable date of the old collective bargaining agreement and the ratification date of the new contract (the amendable period).

revenue breakage. The recognition of revenue before the airline has performed all its obligations under the sales arrangement because the customer has not required the airline to perform and is unlikely to do so. Revenue breakage consists of refundable and nonrefundable tickets that remain unused past departure date, have continuing validity (valid tickets), and are expected to ultimately expire unused and valid travel vouchers that are not expected to be redeemed prior to their expiration date. See **air traffic liability (ATL) breakage**, **valid ticket**, **invalid ticket**, and **travel voucher**.

revenue passenger. One fare-paying passenger transported by the carrier.

revenue ton mile. One ton of revenue traffic transported one statute mile. Revenue ton miles are computed by multiplying tons of revenue traffic (passengers, freight, mail, and express) by the miles that this traffic is flown.

revenue traffic. Passengers and cargo transported by air for which remuneration is received by the air carrier. Airline employees, passengers redeeming their FFP awards, officers, and directors or other persons, except ministers of religion, who are traveling under reduced-rate transportation authorized by Section 403(b) of the Federal Aviation Act and part 223 of the board's economic regulations. Travel agents, cargo agents, tour conductors traveling at reduced fares, and other passengers and cargo carried for token service charges are not considered revenue traffic. See **nonrevenue traffic**.

rotable parts. Parts that are significant in value and can be repaired and reused such that they typically have an expected useful life approximately equal to the aircraft they support. See **expendable parts** and **repairable parts**.

scheduled departure. A takeoff scheduled at an airport, as set forth in published schedules.

slot. Right allocated to an airline by an airport or government agency granting an airline the right to conduct a landing or takeoff at a specific time.

snowball billing. The billing process used in collect air cargo shipments whereby each air cargo carrier that participates in a collect shipment bills the adjacent downline air cargo carrier in the route segment for all transportation services up to the point of transfer to that air cargo carrier, thus "snowballing" the bills to the collecting air cargo carrier. This is done because upline air cargo carriers, due to shipment rerouting, frequently do not know the identity of the collecting air cargo carrier.

tariff. The notice of fares and rates applicable to the transportation of persons or property and the rules relating to or affecting such fares and rates of transportation.

time-and-material contract. An arrangement for outsourcing scheduled maintenance activities. Traditional time-and-material contracts may fix certain components of the cost, but much of the contract price is based on actual cost at the time the maintenance event takes place. See **power-by-the-hour (PBTH) contract**.

traffic expense. Expense that relates to, and varies with, the traffic (passenger or cargo or both) actually transported. It includes such cost elements as traffic servicing expenses, reservations and sales expense, and advertising and publicity expense.

traffic servicing expense. Compensation of ground personnel and other expenses incurred on the ground incident to handling traffic of all types and classes on the ground subsequent to the issuance of documents establishing the air carrier's responsibility to provide air transportation. It includes expenses attributable to the operation of air traffic offices but not costs of reservation sales centers. It also includes expenses of enplaning and deplaning traffic.

travel agent commission. The payment by airlines to a travel agent of specified amounts of money in return for the agent's sales of air transportation.

travel voucher. Certificate for free or discounted travel that is generally issued in connection with denied boarding situations or as an enticement to accept a voluntary change in flights. Travel vouchers may also be issued to passengers as compensation related to other customer service issues. Travel vouchers are usually issued for either free travel or for a fixed amount that can be used by the passenger to pay for future travel purchases from the issuing airline.

unearned transportation revenue. See **air traffic liability**.

unmatched usage. It occurs when a passenger uses a ticket, and the airline has no record of the original ticket sale.

valid ticket. A ticket that maintains its validity (that is, the ticket has value, and the customer can travel with the ticket, exchange it for future travel, or obtain a refund) until its contractual expiration date. See **invalid ticket**.

wet lease. An aircraft lease in which the lessor provides the aircraft, the crew, fuel, maintenance, and other services necessary to operate the flight.

yield. The average revenue per unit of traffic carried in revenue service. Usually, yield is calculated as average revenue per revenue passenger mile, or cents per RPM. For cargo, it is calculated as average revenue per cargo revenue per ton mile, or cents per CTM.

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