1987

Proposed statement of position : Accounting for frequent travel award programs, developmental and preoperating costs, purchases and exchanges of take-off and landing slots, and airframe modifications ;Accounting for frequent travel award programs, developmental and preoperating costs, purchases and exchanges of take-off and landing slots, and airframe modifications; Exposure draft (American Institute of Certified Public Accountants), 1987, June 30

American Institute of Certified Public Accountants. Task Force on Airlines

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR FREQUENT TRAVEL AWARD PROGRAMS, DEVELOPMENTAL AND PREOPERATING COSTS, PURCHASES AND EXCHANGES OF TAKE-OFF AND LANDING SLOTS, AND AIRFRAME MODIFICATIONS

Amendment to
AICPA Industry Audit Guide, Audits of Airlines

JUNE 30, 1987

Prepared by the Task Force on Airlines
Federal Government Relations Division
American Institute of Certified Public Accountants

Comments should be received by August 31, 1987, and addressed to
William J. Holmes, Technical Manager, Federal Government Relations Division, File H-2-700,
AICPA, 1455 Pennsylvania Avenue, NW, Washington, DC 20004-1007

SUMMARY

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

1. Until certain practical limitations and cost benefit considerations have been overcome, the incremental cost of providing free travel awards generally should be accrued when the award levels are achieved. However, when the airlines' accounting systems are sufficiently developed, a portion of the revenue applicable to each ticket sold to a program member should be deferred until earned.

2. Developmental costs related to preparation of operations of new routes should not be capitalized as previously permitted under the AICPA Industry Audit Guide, Audits of Airlines ("the guide"). However, preoperating costs related to integration of new types of aircraft would continue to be eligible to be capitalized, as permitted by the guide. The amortization period for such deferred preoperating costs should begin when the new aircraft is ready to be placed in service.

3. The costs of acquiring take-off and landing slots are identifiable intangible assets that should be accounted for in conformity with Accounting Principles Board (APB) Opinion No. 17, Intangible Assets. When airlines exchange slots, the slots acquired should be recorded in conformity with APB Opinion No. 17 and APB Opinion No. 29, Accounting for Nonmonetary Transactions.

4. The costs associated with airframe modifications that enhance the usefulness of the aircraft should be capitalized and depreciated over the lesser of the estimated useful lives of the aircraft or the modifications. The cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period.

The provisions of this statement would be effective for transactions initiated after December 31, 1987.

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June 30, 1987

Accompanying this letter is an exposure draft of a proposed AICPA statement of position (SOP), Accounting for Frequent Travel Award Programs, Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications, prepared by the Task Force on Airlines. A summary of the proposed SOP also accompanies this letter.

The purpose of the exposure draft is to solicit comments from representatives of airlines and other interested parties. The proposed SOP is an amendment to the AICPA Industry Audit Guide, Audits of Airlines. It was developed to provide guidance on accounting for certain types of transactions and events that have arisen since deregulation of the airline industry.

Comments or suggestions on any aspect of this exposure draft will be appreciated. In addition, commentators are especially asked to give their views on (1) the use of the cost recognition method rather than revenue deferral method in accounting for frequent travel award programs, (2) the proposed changes in accounting for developmental costs related to preparation of operations of new routes, and (3) the commencement of the amortization period for deferred preoperating costs related to integration of new types of aircraft.

It will be helpful if the responses refer to the specific paragraph numbers and include reasons for any suggestions or comments.

Comments on this exposure draft should be sent to William J. Holmes, Technical Manager, Federal Government Relations Division, File No. H-2-700, American Institute of Certified Public Accountants, 1455 Pennsylvania Avenue, NW, Washington, DC 20004-1007, in time to be received by August 31, 1987.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA for one year after September 30, 1987.

Finally, comments received by the AICPA will be considered by the FASB when it reviews the final SOP to determine whether to designate as preferable the accounting principles and practices contained in the SOP.

Yours truly,

Walter Schuetze

Walter Schuetze, Chairman
Accounting Standards Executive Committee

Thomas E. Sinton

Thomas E. Sinton, Jr., Chairman
Task Force on Airlines

ACCOUNTING FOR FREQUENT TRAVEL AWARD PROGRAMS, DEVELOPMENTAL AND PREOPERATING COSTS, PURCHASES AND EXCHANGES OF TAKE-OFF AND LANDING SLOTS, AND AIRFRAME MODIFICATIONS

INDUSTRY DEVELOPMENTS

Deregulation

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

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

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

International Air Transportation

4. Airline operations between countries continue to be governed by specific bilateral agreements between the countries. The access of U.S. airlines to routes between the United States and other countries requires the approval of the respective countries for both landing rights at specified airports and frequency of flights.

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

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

Air Transport Association of America

7. 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.

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

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

Regional Airline Association

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

Regulations and Reporting

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

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

Computerized Reservation Systems

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

14. The CRS vendors receive booking fees per segment from participating airlines on which flights are booked and user fees from the travel agencies. Some airlines have contracted with the CRS vendor to process all of its reservations through the CRS vendor's reservation system, thereby eliminating the need for the airlines' in-house reservation systems.

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

Marketing Arrangements

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

Commissions

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

ACCOUNTING ISSUES

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

Frequent Travel Award Programs

19. Because deregulation has permitted airlines to set their own fares, numerous discount and promotional fares have been put into effect. In addition to special promotional fares that may involve free or heavily discounted tickets that are instituted from time to time, many airlines have programs that grant free or discount air travel or other awards to frequent travelers who enroll as members of those programs. In general, awards under the programs are earned when passengers fly specified numbers of flights or miles with the sponsoring airlines. Other airlines and other travel-related businesses, for example, hotels and car rental companies, participate in these programs. Program members may earn credit toward awards by purchasing goods and services from the participating enterprises.

20. In many of the frequent travel award programs, passengers earn the right to either upgrade a ticket purchased at the published price to another class of service or purchase tickets at a discount off the published price--for example, two tickets for the price of one. These types of awards represent offers to sell transportation to qualified persons (program members) at reduced rates and are considered discounted transportation. The level of award that a passenger earns increases as the number of flights or miles flown increases. At specific levels identified in the rules of each plan, the levels of awards increase from discounted transportation to one or more free round-trip tickets on either the airline sponsoring the program or another participating airline. Many awards also include discounted or free hotel rooms and car rentals with the participating enterprises.

21. Because awards representing discounted transportation are offers to sell transportation at reduced rates, the revenue accounting process commences when program members purchase discount tickets issued under the program. As with other ticket sales, the amounts received on the sale of the discounted tickets should be recorded as unearned revenue when the sales are made and included in revenue when trips are taken.

22. Division's Conclusions. The Accounting Standards Executive Committee (AcSEC) believes that, in concept, a portion of revenue should be deferred until free travel awards are used by passengers. AcSEC recognizes, however, the practical limitations and cost-benefit considerations that currently preclude such accounting. AcSEC also is aware that current practice is to accrue incremental costs when free travel award levels are achieved.

23. In view of the practical limitations and cost-benefit considerations, the majority of AcSEC believes that the cost of providing free travel awards generally should be accrued when the free travel award levels are achieved. An airline should record only the incremental costs associated with the free trips because (a) the trips are offered on only regularly scheduled flights,

(b) the number of seats available to free travelers on flights can be limited, and (c) the costs incurred are only incremental costs. They include food and beverage costs, fuel expenses, passenger liability insurance costs, and travel agency commissions.

24. Factors affecting the amount of costs associated with free tickets to be accrued include the following:

- o The number of awards earned that may not be used
- o The number of awards that may be used for flights on participating airlines rather than the sponsoring airline, which may result in reduced cost to the sponsoring carrier
- o The number of awards that may result in travel agencies issuing tickets, thus requiring the payment of an agency commission
- o Route segments on which awards are expected to be used

In addition, the cost, if any, of awards for other than free travel should also be accrued when the award levels are achieved. The other awards may include free or discounted hotel visits, car rentals, and so forth.

25. A minority of AcSEC believes that a portion of the revenue applicable to each ticket sold to a program member should be deferred until the free tickets expected to be awarded are used, at which time that deferred revenue would be recognized in income.

26. When accounting systems are sufficiently developed, AcSEC believes that revenues should be deferred until earned.

Developmental and Preoperating Costs

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

> Developmental costs include those types of costs directly related to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and expenses of regulatory proceedings.
>
> Preoperating costs include flight crew training, maintenance training, prerevenue flight expenses, insurance, and depreciation. Like developmental costs, preoperating costs relate directly to specific preoperating projects, such as preparation for operation of new routes . . . or integration of new types of aircraft. . . .

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

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

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

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

32. A minority of AcSEC believes that the current accounting model permits the capitalization of developmental costs. They believe the airline industry should not be precluded from capitalizing those costs, which are permitted to be capitalized in other industries.

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

Take-off and Landing Slots

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

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

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

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

37. When an airline exchanges slots with another airline, the slots acquired in the exchange are nonmonetary assets that should be recorded in conformity with APB Opinion No. 17 and APB Opinion No. 29, Accounting for Nonmonetary Transactions.

Airframe Modifications

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

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

EFFECTIVE DATE

40. The conclusions in this statement of position should be applied to transactions initiated after December 31, 1987, although earlier application is encouraged.