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Risks of material misstatement: Airlines

Note: This practice aid is intended to help auditors identify risks of material misstatement (RMM) in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This publication is an *other auditing publication* as defined in 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). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

In applying the auditing guidance included in an *other auditing publication*, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. This document has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

Instructions

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires that the auditor identify and assess the risks of material misstatement (RMM) at the financial statement level and relevant assertion level for classes of transactions, individual account balances, and disclosures to provide a basis for performing further audit procedures. RMM includes both inherent risk and control risk.

To aid auditors in meeting this requirement, this document includes information that could be useful in assessing RMM in the airline industry. **These examples do not include all RMM that could apply or be relevant.**

Refer to the AICPA's *Airlines – Audit & Accounting Guide* for further information on auditing clients in the airline industry.

Inherent risk

The following are characteristics that may indicate increased inherent risk:

- Management characteristics
  - One person dominates management's operating and financing decision making process.
  - Management places undue emphasis on meeting earnings projections, share price, industry targets, maintaining or improving yield.
  - Management places undue emphasis on achieving certain results in order to communicate or disclose financial information to labor unions.
  - Management compensation is significantly influenced by earnings, share price, or other contract characteristics.
  - Management lacks experience in addressing the airline industry issues, emerging issues, or other complex matters.
  - Staff turnover is high, personnel are inexperienced, or staff levels are insufficient given the volume or kind of business processed.
  - Decision making is decentralized and lacks adequate monitoring if in various operating segments.
- Operating and industry characteristics

- Key financial indicators of the airline significantly differ from industry averages or are inconsistent with the entity's historical operations.
    - The airline is poorly rated by the rating agencies or has had a recent change in rating.
    - Operating results significantly differ from projected results.
    - Market share is changing due to increased competition.
    - 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.
    - Significant off-balance sheet risks exist including variable interest entities in leasing structures.
    - Complex nature of hedging arrangements.
    - Internal or external circumstances raise substantial doubt about the airline's ability to continue as a going concern.
    - A large number of reporting units or segments in the airline.
    - Economic dependence of a subsidiary on the mainline operations.
    - Regional airlines significant disputes or disagreements in settlement of billings for capacity purchase agreements.
- Engagement characteristics
    - Contentious or difficult accounting issues are present.
    - Unusual transactions entered into during the year such as derivative instruments or complex leasing transactions.
    - 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.
    - The number or amounts of adjustments in prior periods have been significant.
    - 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.
    - Investigations or significant inquiries by regulators.
    - Increased risk associated with pressure to meet debt covenants or other liquidity metrics (for example, credit card holdback covenants).

Control risk

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.

Fraud

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:

- Revenue accounting 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.
- Maintenance and engineering accounting.
- Subjective accrued liabilities, including the areas of employee compensation, and labor related agreements as well as environmental liabilities.

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