

[Cash Flows, ratios, taxes, leases]

90 minutes

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UAL Corporation ("UAL" or the "Company") was incorporated under the laws of the State of Delaware on December 30, 1968. The world headquarters of the Company are located at 1200 East Algonquin Road, Elk Grove Township, Illinois 60007. The Company's mailing address is P.O. Box 66919, Chicago, Illinois 60666. The telephone number for the Company is (847) 700-4000. The Company is a holding company and its principal subsidiary is United Air Lines, Inc., a Delaware corporation ("United"), which is wholly-owned. United accounted for virtually all of the Company's revenues and expenses in 1996. United is a major commercial air transportation company.

Enclosed are sections of the financial statements of UAL and selected notes to financial statements.

Questions

1 Prepare a statement of cash flows of UAL for the Year Ended December 31, 1996.

You can make the following assumptions:

☞ Depreciation on owned operating property and equipment:	420
Amortization of Intangibles	245
☞ Proceeds from sale of Operating property and equipment	55
Gain from sale of Operating property and equipment is	zero

☞ On July 12, 1994, the shareholders of UAL Corporation ("UAL") approved a plan of recapitalization that provides an approximately 55% equity and voting interest in UAL to certain employees of United Air Lines, Inc. ("United") in exchange for wage concessions and work-rule changes. The employees' equity interest is being allocated to individual employee accounts through the year 2000 under Employee Stock Ownership Plans ("ESOPs") which were created as part of the recapitalization. Since the ESOP shares are being allocated over time, the current ownership interest held by employees is substantially less than 55%. The entire ESOP voting interest is currently exercisable, which generally will be voted by the ESOP trustee at the direction of, and on behalf of, the employees participating in the ESOPs. All the new equity issued in 1996 was given to the employees through the ESOP. Under GAAP and tax guidelines, the fair value of the equity (including preferred stock) raised for ESOP is considered as expense for the period.

2 Compute the following ratios for the year ending December 31, 1996

2a Effective tax rate	2d Return on assets (after tax)
2b Times interest earned	2e Return on Equity
2c Debt to Equity as of December 31, 1996	

☞ Use the figure given as "Earnings before extraordinary item and cumulative effect of accounting change" for net income. That is ignore the items: "Extraordinary loss on early extinguishment of debt, net of tax" and "Cumulative effect of accounting change, net of tax"

Use Note 6 for the following questions.

3a What was the federal statutory income tax rate for UAL in 1996 ?

3b What was the average state statutory income tax rate for UAL in 1996 ?

3c How much nondeductible meals did UAL give its employees ?

3d What was the depreciation expense claimed in the tax return by UAL for the year ending December 31, 1996? [For purposes of answering this question, assume transfers of tax benefits equal zero].

4a Footnote 9 gives the details of the lease obligations of United Airlines. Compute the average interest rate on capital leases as of December 31, 1996 using next period's minimum lease payment and the

current portion of the capital leases in the balance sheet.

4b Compute the average interest rate on capital leases as of December 31, 1996 using all future minimum lease payments. Assume that the capital lease MLPs listed for years after 2001, will be paid equally over 6 years.

To reduce your work the following two tables are given for two discount rates. Needless to say, the correct discount rate is one of the two. Table 1 gives the present value of the first five years' minimum lease payments under the two discount rates. Table 2 gives the standard values of the present value factor and the annuity factors. Try these two values and deduce the lease discount rate.

Table 1

For the	At discount rate	6.78%	7.78%
cash stream	Present value	929	904

233
236
210
186
261

Table 2

At discount rate

Years	6.78%		7.78%	
	Present value	Present value of annuity	Present value	Present value of annuity
1	0.937	0.937	0.928	0.928
2	0.877	1.814	0.861	1.789
3	0.821	2.635	0.799	2.587
4	0.769	3.404	0.741	3.329
5	0.720	4.125	0.688	4.016
6	0.675	4.799	0.638	4.654
7	0.632	5.431	0.592	5.246
8	0.592	6.023	0.549	5.795

Suppose you want to consider the operating leases of UAL as capital leases from December 31, 1995. Using the lease discount rate that you obtained in question 4b, convert the operating leases as of December 31, 1995 into capital leases . Assume that the operating lease MLPs listed for years after 2001, will be paid equally over 8 years and that the operating lease assets have useful life (for depreciation) of 14 years. Table 3 gives the present value of the first five years' MLPs operating lease at the two discount rates.

Table 3
Operating Leases

For the	At discount rate	6.78%	7.78%
\$ stream	Present value	5,775	5,623
1,416			
1,405			
1,386			
1,392			
1,398			

4c What changes need to be made in the balance sheets of December 31, 1995 and 1996 ?

4d What changes need to be made in the income statement for the year ending December 31, 1996 ? Compute the following ratios if the operating leases are accounted as capital leases.

4e Times interest earned **4f** Debt to Equity **4g** Return on assets (after tax)

4f If you were a lender to UAL, what other off-balance-sheet liabilities should you be concerned with ?

UAL Corporation and Subsidiary Companies
Statements of Consolidated Operations

Year Ended December 31	1996	1995	1994
Operating revenues:			(In Millions, Except Per Share)
Passenger	14,465	13,227	12,295
Cargo	773	757	685
Other operating revenues	1,124	959	970
	16,362	14,943	13,950
Operating expenses:			
Salaries and related costs	4,719	4,526	4,679
ESOP compensation expense	685	504	182
Aircraft fuel	2,082	1,680	1,585
Commissions	1,466	1,471	1,426
Purchased services	1,187	1,062	947
Aircraft rent	952	1,009	933
Landing fees and other rent	846	803	622
Depreciation and amortization	759	724	725
Aircraft maintenance	449	407	410
Other operating expenses	2,094	1,928	1,920
	15,239	14,114	13,429
Earnings from operations	1,123	829	521
Other income (expense):			
Interest expense	(295)	(399)	(372)
Interest capitalized	77	42	41
Interest income	57	98	85
Equity in earnings of affiliates	64	48	20
Miscellaneous, net	(56)	3	(124)
	(153)	(208)	(350)
Earnings before income taxes, extraordinary item and cumulative effect of accounting change	970	621	171
Provision for income taxes	370	243	94
Earnings before extraordinary item and cumulative effect of accounting change	600	378	77
Extraordinary loss on early extinguishment of debt, net of tax	(67)	(29)	-
Cumulative effect of accounting change, net of tax	-	-	(26)
Net earnings	533	349	51
Per share, primary:			
Earnings before extraordinary item and cumulative effect of accounting change	\$5.96	\$5.46	\$0.19
Extraordinary loss on early extinguishment of debt, net	(\$0.80)	(\$0.46)	-
Cumulative effect of accounting change, net	-	-	(\$0.34)
Net earnings (loss)	\$5.16	\$5.00	\$0.19

Per share, fully diluted:

Earnings before extraordinary item and cumulative effect of accounting change	\$5.82	\$5.18	\$0.19
Extraordinary loss on early extinguishment of debt, net	(\$0.78)	(\$0.40)	-
Cumulative effect of accounting change, net	-	-	(\$0.34)
Net earnings (loss)	\$5.04	\$4.78	\$0.19

See accompanying notes to consolidated financial statements.

UAL Corporation and Subsidiary Companies Statements of Consolidated Financial Position

Assets	(In Millions)	December 31	1996	1995	Change
Current assets:					
Cash and cash equivalents			229	194	35
Short-term investments			468	949	(481)
Receivables, less allowance for doubtful accounts (1996-\$24; 1995-\$19)			962	951	11
Aircraft fuel, spare parts and supplies, less obsolescence allowance (1996-\$31; 1995-\$38)			369	298	71
Deferred income taxes			227	236	(9)
Prepaid expenses and other			427	415	12
			2,682	3,043	(361)
Operating property and equipment:					
Owned:	Flight equipment		8,393	7,778	
	Advances on flight equipment		943	735	
	Other property and equipment		2,989	2,700	
			12,325	11,213	1,112
Less - Accumulated depreciation and amortization			5,380	5,153	227
			6,945	6,060	885
Capital leases:	Flight equipment		1,775	1,362	
	Other property and equipment		106	102	
			1,881	1,464	417
Less - Accumulated amortization			583	503	80
			1,298	961	337
Other assets:					
Intangibles,					
	less accumulated amortization (1996-\$353; 1995-\$306)		524	763	(239)
Deferred income taxes			132	238	(106)
Aircraft lease deposits			168	71	97
Other			928	505	423
			1,752	1,577	175
Total assets			12,677	11,641	Average 12,159

See accompanying notes to consolidated financial statements.

Liabilities and Shareholders' Equity

(In Millions) December 31	1996	1995	Change
Current liabilities:			
Long-term debt maturing within one year	165	90	75
Current obligations under capital leases	132	99	33
Advance ticket sales	1,189	1,100	89
Accounts payable	994	696	298
Accrued salaries, wages and benefits	906	870	36
Accrued aircraft rent	800	771	29
Other accrued liabilities	817	807	10
	5,003	4,433	570
Long-term debt	1,661	2,919	(1,258)
Long-term obligations under capital leases	1,325	994	331
Other liabilities and deferred credits:			
Deferred pension liability	178	368	(190)
Postretirement benefit liability	1,290	1,225	65
Deferred gains	1,151	1,214	(63)
Accrued aircraft rent	352	272	80
Other	424	336	88
	3,395	3,415	(20)
Company-obligated mandatorily redeemable preferred securities of a subsidiary trust	102		102
Minority interest	31	59	(28)
Preferred stock committed to Supplemental ESOP	165	60	105
Shareholders' equity:			
Common stock at par, \$0.01 par value; authorized 200,000,000 shares; issued 59,519,096 shares at December 31, 1996 and 51,195,657 shares at December 31, 1995	1	-	1
Additional capital invested	2,160	1,353	807
Accumulated deficit	(566)	(1,039)	473
Unearned ESOP preferred stock	(202)	(175)	(27)
Stock held in treasury -			
Preferred (Note 12)	(302)	(218)	(84)
Common, 701,616 shares at December 31, 1996 and 477,233 shares at December 31, 1995	(83)	(64)	(19)
Other	(13)	(96)	83
	995	(239)	1,234
	12,677	11,641	1,036

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

(g) Operating Property and Equipment - Owned operating property and equipment is stated at cost. Property under capital leases, and the related obligation for future minimum lease payments, are initially recorded at an amount equal to the then present value of those lease payments.

Depreciation and amortization of owned depreciable assets is based on the straight-line method over their estimated service lives. Leasehold improvements are amortized over the remaining period of the lease or the estimated service life of the related asset, whichever is less. Aircraft are depreciated to estimated salvage values, generally over lives of 10 to 30 years; buildings are depreciated over lives of 25 to 45 years; and other property and equipment are depreciated over lives of 3 to 15 years.

Properties under capital leases are amortized on the straight-line method over the life of the lease, or in the case of certain aircraft, over their estimated service lives. Lease terms are 10 to 30 years for aircraft and flight simulators and 25 years for buildings. Amortization of capital leases is included in depreciation and amortization expense.

Maintenance and repairs, including the cost of minor replacements, are charged to maintenance expense accounts. Costs of additions to and renewals of units of property are charged to property and equipment accounts.

(h) Intangibles - Intangibles consist primarily of route acquisition costs and intangible pension assets (see Note 15). Route acquisition costs are amortized over 40 years.

(i) Mileage Plus Awards - United accrues the estimated incremental cost of providing free travel awards earned under its Mileage Plus frequent flyer program (including awards earned from mileage credits sold) when such award levels are reached. United, through its wholly-owned subsidiary, Mileage Plus Holdings, Inc., sells mileage credits to participating partners in the Mileage Plus program. The resulting revenue is recorded in other operating revenues during the period in which the credits are sold.

(j) Deferred Gains - Gains on aircraft sale and leaseback transactions are deferred and amortized over the lives of the leases as a reduction of rental expense.

(6) Income Taxes

In 1996, the regular tax liability of the Company exceeded the alternative minimum tax ("AMT") liability resulting in a utilization of AMT credits. The federal income tax liability is the greater of the tax computed using the regular tax system or the tax under the AMT system. However, if the regular tax liability exceeds the AMT liability and AMT credits are available, the AMT credits are used to reduce the net tax liability to the amount of the AMT liability. During 1996, UAL utilized \$34 million of AMT credits.

The provision for income taxes is summarized as follows:

(In Millions)		1996	1995	1994
Current -	Federal	281	29	12
	State	20	-	4
		301	29	16
Deferred -	Federal	47	187	73
	State	22	27	5
		69	214	78
Total		370	243	94

The income tax provision differed from amounts computed at the statutory federal income tax rate, as follows:

(In Millions)	1996	1995
Income tax provision at statutory rate	339	217
State income taxes, net of federal income tax benefit	28	18
ESOP dividends	(13)	(5)
Nondeductible employee meals	25	23
Foreign tax credits	(2)	(2)
Other, net	(7)	(8)
	370	243

Temporary differences and carryforwards which give rise to a significant portion of deferred tax assets and liabilities for 1996 and 1995 are as follows:

(In Millions)	1996		1995	
	Tax Assets	Tax Liabilities	Tax Assets	Tax Liabilities
Employee benefits, including postretirement medical	644	93	594	92
Depreciation, capitalized interest and transfers of tax benefits		1,172		1,077
Gains on sale and leasebacks	428		450	
Rent expense	351		310	
AMT credit carryforward	231		265	
Net operating loss carryforwards	11		123	
Other	263	304	183	282
	1,928	1,569	1,925	1,451

At December 31, 1996, UAL and its subsidiaries had \$231 million of federal AMT credit carryforwards available for an indefinite period, \$4 million of general business credit carryforwards which expire between 2003 and 2007, \$5 million of foreign tax credit carryforwards expiring between 2000 and 2001, \$8 million of state tax benefit from net operating loss carryforwards expiring between 1999 and 2011 and \$3 million of federal tax benefit from net operating loss carryforwards expiring in 2007.

UAL's ability to generate sufficient amounts of taxable income from future operations is dependent upon numerous factors, including general economic conditions, inflation, fuel costs, the state of the industry and other factors beyond management's control. There can be no assurances that UAL will meet its expectation of future taxable income. However, based on the extended period over which postretirement benefits will be recognized, and the indefinite carryforward period for AMT credits, management believes it is more likely than not that future taxable income will be sufficient to utilize the deferred tax assets at December 31,1996.

(9) Lease Obligations

The Company leases aircraft, airport passenger terminal space, aircraft hangars and related maintenance facilities, cargo terminals, other airport facilities, real estate, office and computer equipment and vehicles.

Future minimum lease payments as of December 31,1996, under capital leases (substantially all of which are for aircraft) and operating leases having initial or remaining noncancelable lease terms of more than one year are as follows:

(In Millions)	Operating Leases			Capital Leases	
	Aircraft	Non-Aircraft	Total		
Payable during					
	1997	943	473	1,416	233
	1998	942	463	1,405	236
	1999	939	447	1,386	210
	2000	957	435	1,392	186
	2001	939	459	1,398	261
After 2001		3,403	7,871	11,274	1,036
Total minimum lease payments		8,123	10,148	18,271	2,162
Imputed interest (at rates of 5.3% to 12.2%)					(705)
Present value of minimum lease payments					1,457

As of December 31,1996, United leased 298 aircraft, 54 of which were under capital leases. These leases have terms of 4 to 26 years, and expiration dates range from 1997 through 2020.

In connection with the financing of certain aircraft accounted for as capital leases, United had on deposit at December 31,1996 an aggregate 19 billion yen (\$168 million) in certain banks and had pledged an irrevocable security interest in such deposits to the aircraft lessors. These deposits will be used to pay off an equivalent amount of recorded capital lease obligations.

Amounts charged to rent expense, net of minor amounts of sublease rentals, were \$1.424 billion in 1996, \$1.439 billion in 1995, and \$1.222 billion in 1994. Included in 1996 rent expense was \$15 million in contingent rentals, resulting from changes in interest rates for operating leases under which the rent payments are based on variable interest rates. In connection with certain of these leases, United has entered into interest rate swap agreements (see Note 17).

(18) Commitments, Contingent Liabilities and Uncertainties

The Company has certain contingencies resulting from litigation and claims (including environmental issues) incident to the ordinary course of business. Management believes, after considering a number of factors, including (but not limited to) the views of legal counsel, the nature of contingencies to which the Company is subject and its prior experience, that the ultimate disposition of these contingencies is not expected to materially affect UAL's consolidated financial position or results of operations. UAL records liabilities for legal and environmental claims against it in accordance with generally accepted accounting principles. These amounts are recorded based on the Company's assessments of the likelihood of their eventual settlements. The amounts of these liabilities could increase in the near term, based on revisions to estimates relating to the various claims.

At December 31, 1996, commitments for the purchase of property and equipment, principally aircraft, approximated \$6.9 billion, after deducting advance payments. An estimated \$2.9 billion is due to be spent in 1997, \$1.9 billion in 1998, \$1.0 billion in 1999 and \$1.1 billion in 2000 and thereafter. The above amounts reflect firm orders for 21 B747, 6 B757, 20 B777, 14 A320 and 24 A319 aircraft to be delivered through 2002. However, these amounts do not include a recent order for an additional three A320 and four A319 aircraft. Under the Company's current fleet plan, the above aircraft will principally be used to replace older aircraft which will be retired. As a result, the Company expects only modest growth in its passenger fleet through 2002.

Consistent with UAL's strategic plan and the Company's focus on attracting more high yield passengers, the Board of Directors has authorized an investment of approximately \$400 million in United's onboard product, including new aircraft seats and other cabin improvements. This amount, which is expected to be spent in the next three years, is not reflected in the above commitments.

In connection with the construction of the Indianapolis Maintenance Center, United agreed to spend an aggregate \$800 million on capital investments by the year 2001 and employ at least 7,500 individuals by the year 2004. In the event such targets are not reached, United may be required to make certain payments to the city of Indianapolis and state of Indiana.

Approximately 60% of United's employees are represented by various labor organizations. In connection with the 1994 employee investment transaction, members of the Air Line Pilots' Association and the International Association of Machinists and Aerospace Workers entered into labor contracts with United which become amendable in 2000.

United's contract with the Association of Flight Attendants ("AFA") became amendable March 1, 1996. On April 9, 1996, United announced that the flight attendants had rejected a previously announced tentative agreement. United and the AFA are involved in traditional negotiations under the Railway Labor Act, which historically have taken several years to complete. While negotiations continue, the terms of United's current flight attendant agreement will remain in effect.