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Technical Line

FASB — final guidance

The new revenue recognition standard — airlines

Airlines will have to change how they account for loyalty programs, which could affect their financial results.

What you need to know

- The new revenue recognition standard is more principles-based than current revenue guidance and will require airline entities to exercise more judgment.
- Airlines will have to change how they account for loyalty programs, which could affect their financial results.
- They also may need to change their income statement presentation for inter-airline billings, ancillary services and passenger ticket breakage.
- The new standard is effective for public entities for fiscal years beginning after 15 December 2016, including interim periods within those years, and for nonpublic entities in years beginning after 15 December 2017.

Overview

Airlines likely will need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including industry-specific guidance that airline entities use today.

The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements, such as the leasing literature). We expect that the new revenue recognition guidance will apply to substantially all airline revenue transactions.

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Our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), provides an in-depth discussion of the new revenue standard. This publication summarizes certain implications for airlines.

Airlines also may want to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on airline issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's airline industry task force is one of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance issued by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our guidance.

Key considerations

Airlines will have to change both the pattern of revenue recognition and the presentation of revenue under the new standard. They will have to carefully consider the facts and circumstances to determine the appropriate treatment for frequent flyer or other loyalty programs, inter-airline billings (known as interline billings), ancillary services revenue and passenger ticket breakage.

Frequent flyer or loyalty program accounting

Most airlines offer loyalty programs that allow customers to earn miles or points for flying on the airline or to get points or miles through partner arrangements, such as co-brand credit cards, flights on other airlines and activities with other travel partners such as rental car companies and hotels.

Although points sold through partner arrangements (e.g., co-branded credit card partners) are accounted for as a revenue transaction in accordance with today's revenue recognition guidance, points issued to program participants for using the entity's products and services (i.e., airline passengers) can been accounted for as an accrued expense under US GAAP using the incremental cost method.

Under the incremental cost method, the loyalty provider does not consider its issuance of points to be a revenue element, generally because the points are relatively insignificant when compared with the overall value of the transaction. Instead, issuing points is considered an obligation to incur certain incremental costs for providing future goods or services to the customer, and airlines that apply this method accrue the direct incremental cost of providing a future free ticket. As many of the costs in the airline industry are of a fixed nature, the incremental cost of providing the additional flight is significantly lower than the standalone selling price of the point.

Under the new standard, the Boards concluded that goods and services an entity might currently consider to be marketing incentives or incidental goods or services, including issuing miles or points in frequent flyer or loyalty programs, are goods or services for which the customer pays and to which the entity should allocate consideration (i.e., identify as performance obligations) for purposes of revenue recognition. This is because the miles or points have value to the customer and obligate the airline to provide a future good or service. This conclusion will require airlines to defer revenue for their loyalty programs until the related performance obligations are satisfied. This could have a material effect on an airline's financial results for entities currently accounting for loyalty transactions in accordance with the incremental cost method.

Airlines will have to perform a comprehensive analysis of their loyalty programs under the new standard. They will have to determine whether additional distinct goods and services are offered in a co-brand credit card arrangement. They also will have to account for unlimited services offered to loyalty program members and determine whether a significant financing component exists for prepaid miles that are outstanding for more than one year.

How we see it

Airline entities moving from an incremental cost method to treating loyalty points as a revenue element will have to allocate some portion of the transaction price to the loyalty element, based on the estimated standalone selling price of each performance obligation. Airlines that have treated miles or points sold to partners, such as co-brand credit card providers, as revenue elements should be able to use that model as a starting place for the estimates necessary to value flown miles. However, the new guidance may affect the valuation of the miles.

Interline transactions

Some airlines (the selling airline) have arrangements with other airlines (the operating airline) to sell tickets that will be flown (fully or partially) by the operating airline. The transactions are settled when the passenger is flown by the operating airline, with the operating airline billing the selling airline, based on the terms of what is called the interline agreement. The operating airline is directly responsible to the passenger for the flight when it occurs, but prior to that point, the customer must work with the selling airline for any changes or modifications.

The timing of revenue recognition may change if ancillary services are not determined to be distinct.

Under today's industry-specific guidance, airlines record these transactions on a net basis within passenger revenue (i.e., payments are recorded as a reduction in the air traffic liability balance sheet account and the only effect on revenue is for any billing differences). Under the new standard, airlines will have to evaluate these transactions and determine whether the selling airline is acting as a principal or an agent in the transaction with the operating airline.

If the selling airline is a principal in the sale of the ticket, it will present the full selling price as revenue and the amount paid to the operating airline as a cost (i.e., on gross basis). If a gross conclusion were to be reached, it would be a significant change in presentation on an airline's income statement.

Ancillary services

Airlines frequently charge separately for a variety of ancillary services, which are currently accounted for as separate units of accounting from the purchased ticket. An airline also may charge some customers for a particular ancillary service but offer the same service to other customers (such as elite frequent flyers) free of charge. The most significant ancillary services include change fees (charged for making a change to certain advance purchase tickets), charges for checked and other baggage, and charges for priority seating and other types of priority access.

The new standard will require airlines to evaluate whether each ancillary service is distinct (i.e., both capable of being distinct and distinct within the context of the contract) and, therefore, a separate performance obligation. If an ancillary service is accounted for as a separate performance obligation, the airline will be required to recognize the amount allocated to the performance obligation once it provides the service, regardless of whether the airline charges separately for such service.

If the ancillary service is not a separate performance obligation, it would be combined with the passenger ticket and likely be recognized as a component of passenger revenue (because most ancillary services are associated with the primary passenger ticket). This would be a change in industry practice for the presentation of ancillary service revenue.

The timing of revenue recognition for these fees may also change. Today, certain fees (primarily ticket change fees) associated with ancillary services are recognized at a date other than the flight date.

Passenger ticket breakage

Because airline tickets are purchased in advance, there is a possibility that tickets may go unused (or unexercised) by passengers at the flight date. While the airlines offer both refundable and nonrefundable tickets, both ticket types have the potential to go unused. Unused tickets, also known as breakage, represent revenue to the airline for unused tickets related to nonrefundable consideration paid to the airline (or refundable consideration for which the refund provisions have lapsed). Under current guidance, airlines have the option to recognize breakage revenue at expiration using the expiration method (when the ticket is unused at flight date or expires) or in advance using the redemption method (generally based on the pattern of associated flown revenue). Under US GAAP, the expiration method generally has been considered the preferable method.

Under the new standard, an airline must estimate unexercised rights and recognize expected breakage as revenue in proportion to the pattern of rights exercised by the customer. The result will be similar to today's redemption method, and as a result, the new model eliminates the expiration model. This will be a significant change from current practice for airlines that apply the expiration method.

Next steps

- Entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, entities may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.
- Entities also may want to monitor the discussions of the Boards, the Securities and Exchange Commission (SEC) staff, the TRG and the airline industry task force formed by the AICPA to discuss interpretations and application of the new standard to common transactions.
- Public entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.