Working Draft:

Airlines Revenue Recognition Implementation Issue

Issue #2-3 – Passenger Ticket Breakage and Accounting for Travel Vouchers

Expected Overall Level of Impact to Industry Accounting:

Moderate

Wording to be Included in the Revenue Recognition Guide:

Air Traffic Liability (ATL) Unexercised Customer Rights

1. Passenger tickets sold by the air carrier are recorded as a contract liability (referred to as air traffic liability or *ATL*). Consistent with FASB ASC 606-10-55-46, ATL is reduced and revenue is recognized once the performance obligation has been satisfied. ATL represents the value of unused transportation sold by the air carrier. ATL includes tickets that have been sold with scheduled departure dates in the future as well as certain tickets that are past their scheduled departure date. This includes prepaid ticket sales that remain partially or wholly unused after the scheduled departure date for which some or all of the original ticket value is available to the passenger. Ticket expiration is determined by the airline's contract of carriage; however, generally tickets expire one year from the date of sale. Tickets that expire unused represent unexercised passenger rights and are often referred to as *passenger ticket breakage*. The airline recognizes breakage (or unexercised rights) as revenue consistent with the guidance in FASB ASC 606-10-55-48. As the specific tickets that will ultimately break are not known, the airline estimates and recognizes the expected breakage amount generally at the aggregate level.

Ticket Validity

2. For purposes of this discussion, *ticket validity* refers to the status of the ticket after its scheduled departure date but prior to its contractual expiration date. All unused tickets are either valid or invalid as determined by the specific airline's contract of carriage. Ticket validity represents a ticket that has some value and the customer can exchange it for future travel or obtain a refund up until its contractual expiration date. Some tickets have partial validity. *An invalid ticket* generally loses its value at departure date.

3. Once the customer has purchased a ticket, any of the following events may take place that correspond with the airline's satisfaction or modification of its related performance obligation:
   a. *The airline operates and the customer flies on the designated flight.* In this case, the airline has satisfied its performance obligation and has transported the customer to their destination. The airline has fully

performed on the performance obligation considering the guidance in FASB ASC 606-10-25-23. The ticket is removed from ATL and the related revenue is recognized.

b. *The customer cancels or modifies the ticket.* The customer modifies or cancels the ticket by exchanging it for a ticket on a different flight in advance of the flight date and the contract is appropriately modified. See Issue #2-11, *Change Fees*.

c. *The airline operates the flight but the customer does not show up.* In this instance the determination of performance is based on the airline's performance under the terms of the ticket contract. The primary fact patterns are described below:

   i. *Fully refundable or exchangeable tickets retain their full value past the departure date or tickets that have some value remaining to the customer:* These tickets may remain and ultimately expire unused, resulting in breakage as described subsequently. Also, these tickets that are past their scheduled departure date have no remaining specified performance obligation, but represent effectively a refund liability to the customer (even though the airline may only allow for exchange for another ticket and not actually pay as a refund).

   ii. *Tickets that by their contract terms become invalid if the scheduled flight is not taken by the customer (invalid tickets):* Recognition of revenue should occur once the original flight date has passed for all or a portion of the ticket that has become invalid. If the ticket is non-refundable, in most cases the value paid by the customer is forfeited at the time of departure. If the customer did not exercise their right to fly and did not properly change or cancel the ticket, FinREC believes performance under the original ticket contract (as described in FASB ASC 606-10-25-23) has occurred and the performance obligation is satisfied in accordance with the contract terms because the airline operated the flight and performed fully as required under the contract.

Passenger Ticket Breakage

4. Passenger ticket breakage consists of:
   a. Valid tickets (refundable and nonrefundable tickets that have remaining valid amount available to the customer past the departure date, referred to as *continuing validity*) that are expected to ultimately expire unused and
   b. Valid travel vouchers that are not expected to be redeemed prior to their contractual expiration date.

5. Consistent with FASB ASC 606-10-55-48, if the airline expects to be entitled to breakage on unused tickets, then the airline should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the passenger. If the airline does not expect to be entitled to a breakage amount, the airline should recognize the expected breakage amount as revenue only when the likelihood of the passengers exercising their remaining rights becomes remote, which would occur no later than the expiration date of the ticket.

6. The guidance in FASB ASC 606 specifies the accounting for an individual contract with a customer. However, FASB ASC 606-10-10-4 provides a practical expedient, such that an airline may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. Because airline tickets generally represent a large volume of similar contracts with similar classes of customers, in practice airlines would typically recognize breakage using the portfolio approach. Therefore, the remainder of this paper focuses on the portfolio approach. Recognizing breakage on an individual ticket basis involves additional complexity which is not contemplated in this paper.

7. It is important that airlines exercise judgment when determining portfolios. FASB ASC 606 specifies the need for similar characteristics among contracts (or performance obligations) to be grouped together, but permits the application of a "reasonable approach to determine the portfolios that would be appropriate for its types of contracts," as stated in BC69 of ASU No. 2014-09. The phrase "similar characteristics," as stated in FASB ASC 606-10-10-4, is not explicitly defined. The FASB explained its rationale for including a portfolio practical expedient in BC69-BC70 of ASU No. 2014-09, noting that it would be a practical way to apply FASB ASC 606. The FASB specifically indicated that judgment would be required in selecting the size and composition of the portfolio such that the entity would not expect the portfolio results to differ materially from the application of FASB ASC 606 to each specific contract.

8. FinREC believes that an airline could apply the portfolio approach at different levels of ticket groupings (for example, the portfolio could be viewed as tickets sold in a month or some different time period or at a more granular level, such as tickets by flight segment or separately for domestic and international tickets). Irrespective of how an airline defines the portfolio, if it expects to be entitled to breakage on unused tickets, it should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised and the related revenue recognized for the passengers who flew. For example, if an airline elects to view as a portfolio tickets sold during

a specified time period, recognition of the related breakage associated these tickets would be in proportion to the pattern of tickets flown and recognized from that same time period. Said another way, the recognition of breakage would be in proportion to the pattern of rights exercised by passengers within the portfolio (i.e., those who fly on tickets), resulting in recognition of breakage over time based on the related revenue flown within the portfolio.

9. As indicated in FASB ASC 606-10-55-48, to determine whether an airline expects to be entitled to a breakage amount, it should consider the guidance in paragraphs 11-13 of FASB ASC 606-10-32 on constraining estimates of variable consideration. Specifically, the airline would need to consider the likelihood that any valid amounts remaining on unused tickets after the scheduled departure date will be subsequently used, refunded or otherwise compensated for prior to expiration date. Factors to consider may include but are not limited to the following:
    a. The existence of historical breakage experience and whether that experience has predictive value.
    b. The existence of factors outside the airline's influence that have an impact on breakage (such as major weather or other flight interruption events) that might result in current activity being different from historical breakage rates.
    c. Whether the airline has a practice of either changing ticket validity terms or other contractual usage conditions in similar circumstances. For example, historical customer accommodations (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) would decrease the likelihood of an airline being entitled to a breakage amount prior to ticket expiration date.

10. Airline tickets are contracts between the airline and the passenger and cannot be changed without agreement from both parties. Historically, airlines have purged tickets (both invalid and valid) from their ATL databases or subledgers one year from the date of sale which is generally their legal expiration date. This is a practical process that tracks the expiration of the tickets, and is done irrespective of the airline's breakage revenue recognition policy. Airlines generally estimate and record breakage and reduce the balance of ATL at an overall level using the portfolio approach based on scheduled departure dates as described previously, but will not actually remove the tickets from the ticket databases until the legal expiration date, except in limited cases. Based on historical patterns of ticket purges available to estimate breakage, FinREC believes airlines should estimate the expiration of valid tickets based on historical patterns and record an estimate of passenger ticket breakage in proportion to the exercised rights or flown revenue (e.g. scheduled departure dates).

11. Changes in ticketing rules, such as the amount a customer is charged to make a change to an existing itinerary, can affect expiration patterns and related breakage estimates, and need to be evaluated carefully.

12. Ancillary fees charged separately to customers for various goods and services (such as baggage, seat assignments, priority boarding, and so on), which are not distinct from the transportation provided as discussed in Issue #2-4, *Ancillary Fees and Services*, would need to be combined with the flight into a single performance obligation and accounted for as a bundled transaction consistent with guidance in FASB ASC 606-10-25-22. As a result, any impact associated with ancillary fees on actual ticket breakage would need to be considered, if subject to the same process and procedures. The fact that these services are often purchased separately from the transportation and systematically do not generally link directly with the tickets in ATL adds additional complexity to the breakage estimation process.

Travel Vouchers

13. Travel vouchers are generally issued as an accommodation for the passenger's inconvenience in connection with denied boarding situations in which a passenger is involuntarily denied boarding and placed on another flight. Travel vouchers are also provided as an enticement for passengers to accept a voluntary change in flights, such as in an overbooking situation. The guidance in this section addresses accounting for travel vouchers issued as a result of denied boarding and may not be applicable to all other forms of travel vouchers issued by airlines. In denied boarding situations, the travel voucher is provided to the customer in addition to providing an alternative 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 either to cover the complete cost of a flight (for example, a round trip anywhere in the United States) or for a stated dollar amount (frequently ranging from $100 to $500) that can be used by the passenger to apply towards future travel purchases from the issuing airline. Generally, travel vouchers cannot be exchanged for cash and expire one year from the date of issuance. Completely unused travel vouchers have continued validity generally until their expiration date. However, partially used travel vouchers frequently have no continued validity with regards to any unused value.

14. Issuance of a travel voucher would generally be considered a contract modification as defined in FASB ASC 606-10-25-10. Travel vouchers are recorded as an obligation of the airline at the date of issuance, which is usually the departure date of the ticket for which the voucher was issued. Frequently the airline provides the passenger a

travel voucher as compensation for them agreeing to change the terms of the original contract by taking another flight or changing their plans in some related way. No additional consideration is given by the passenger to obtain the voucher (which represents an additional performance obligation). As such, the issuance of travel vouchers is recorded by allocating the unrecognized consideration received for the original ticket between the remaining performance obligations (that is, the travel voucher issued and the alternate flight provided). FinREC believes the accounting for travel vouchers should follow the contract modification guidance in FASB ASC 606-10-25-13(a) as if the prior contract were terminated and a contract with two separate performance obligations (a new fight and the travel voucher) was issued.

15. Under the requirements in paragraphs 28-41 of FASB ASC 606-10-32, airlines should allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis. FASB ASC 606-10-32-33 indicates that if a standalone selling price is not directly observable, it should be estimated. The estimated standalone selling price of the voucher would generally be based on its face or estimated value, along with a consideration of breakage. The amount recorded at issuance would need to be adjusted so that it reflects the value of only those vouchers (or partial vouchers) that are expected to be redeemed. (This is substantially similar to the fulfillment discount discussed in Issue #2-6(h), *Estimating Standalone Selling Price of Mileage Credits in Customer Loyalty Programs*). For example, if a $500 voucher is issued to a passenger in exchange for agreeing to change to another flight and historical experience indicates that only 60% of the value of such vouchers will be redeemed prior to expiration, the estimated selling price for the voucher issued would be $300, which would be used as a component in the allocation of the transaction price of the original unused ticket between the new flight and the travel voucher. When travel vouchers are exchanged for tickets or used as partial payment on a ticket and subsequently flown, revenue associated with the travel voucher is recognized when the new ticket is flown.

Comments should be received by June 1, 2017, and sent by electronic mail to Yelena Mishkevich at yelena.mishkevich@aicpa-cima.com, or you can send them by mail to Yelena Mishkevich, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.