

## Financial Reporting Center – Revenue Recognition

# Working Draft: Airlines Revenue Recognition Implementation Issue



**Issue #2-5** – Interline Transactions - Identifying Performance Obligations for Air Travel (including at the Segment versus the Ticket Level) and Principal vs. Agent Considerations

**Expected Overall Level of Impact to Industry Accounting:**  
Generally not expected to change current practice

**Wording to be Included in the Revenue Recognition Guide:**

### *Introduction*

- Under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 606-10-05-3, an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
- Because airline tickets are usually sold in advance of the transportation date, the ticket sale date seldom coincides with the revenue recognition date, which is also referred to as the service date. The following describes the twofold task for airline passenger revenue accounting:
  - To record unearned revenue (air traffic liability [ATL]) when a ticket is sold and scheduled service is at a later date
  - To recognize revenue when the carrier provides the transportation service and thereby satisfies the performance obligation.
- Airlines frequently sell tickets for round-trip or multi-city destinations and frequently operate connecting flights. The ticket represents a contract with a customer under FASB ASC 606, *Revenue from Contracts with Customers*. When a ticket includes multiple flight segments, an airline would need to identify separate performance obligations within the contract in accordance with guidance in paragraphs 14-22 of FASB ASC 606-10-25. For example, a passenger purchasing a round-trip ticket from New York to Los Angeles that connects in Dallas would contain the following four flight segments:
  - New York to Dallas
  - Dallas to Los Angeles
  - Los Angeles to Dallas
  - Dallas to New York

4. To identify separate performance obligations within this contract, an airline first would need to evaluate whether each segment in a ticket is capable of being distinct in accordance with guidance in FASB ASC 606-10-25-19(a). Operationally the customer can benefit from each segment on its own. This is supported by the fact that the airline and its competitors regularly sell these segments separately and the customer can purchase a ticket for each segment separately from multiple airlines. Therefore, generally each segment is capable of being distinct.
5. An airline would also need to evaluate whether promises associated with each segment in a ticket are separately identifiable in accordance with FASB ASC 606-10-25-19(b) (that is, the promise is distinct within the context of the contract) considering the factors in FASB ASC 606-10-25-21, as discussed subsequently. Various scenarios are discussed in the following sections; however, overall, FinREC believes each segment in a given itinerary would generally be considered a distinct performance obligation within the context of the contract.

#### *Interline Ticketing*

6. Some airlines issue tickets that may only be used for transportation on the airline's own flights and provide transportation only to passengers holding tickets issued by the selling airline. Those airlines are referred to as non-interline or on-line airlines. Some airlines have agreements with other airlines to provide transportation interchangeably between the carriers. Those airlines are referred to as interline airlines. A ticket sold by one airline that includes flight segments to be traveled on another airline (OAL) is referred to as an interline segment. One ticket can include several flight segments, which may include flights on the selling carrier as well as various OALs. The carrier that issues the ticket and collects the entire sales price is known as the *selling carrier*<sup>1</sup>. The carrier that operates the flight, referred to as the *operating carrier*, settles the fare with the selling carrier on the basis of interline agreements. This settlement occurs once the operating carrier in the interline transaction performs the service of flying the passenger and then bills the selling carrier under their applicable agreements. Interline agreements take many forms ranging from code-share agreements, where one carrier puts its flight number on another carrier's flight, to interlining with non-partners under industry standard agreements that provide a process and protocol as to how the agreements must be settled based on published prices. In a code-share agreement there is generally a bilaterally agreed method of settlement. In interline non code-share agreements the operating carrier receives a segment value based on industry proration agreements unless otherwise bilaterally agreed. Irrespective of the form of the agreement, the amount paid from the selling carrier to the operating carrier is contractually determined by agreement and such payment amount is generally not known to the customer.

#### *Round-Trip Ticket with no Connecting Flights*

7. When determining the nature of its promise to the passenger in a round-trip ticket with no connecting flights (e.g. direct outbound flight from New York to Los Angeles and direct return flight from Los Angeles to New York), the airline would need to consider factors in FASB ASC 606-10-25-21(a)-(c) to determine whether any of the entity's promises are separately identifiable from other promises in the contract in accordance with FASB ASC 606-10-25-19(b). The nature of the overall promise to the passenger is to first transport the passenger to Los Angeles and then separately transport the passenger back to New York.
8. While pricing may have some interdependencies in certain airline pricing schemes (e.g. a round-trip ticket sold by some carriers could be priced lower than two independently purchased one-way tickets on the same route), the airline is not providing a significant integration service of creating a combined item derived from services of the two flights. That is, the airline has promised to transport the passenger to Los Angeles and then to transport the passenger back to New York at a later time.
9. The airline's services on the outbound flight to Los Angeles will not significantly modify the return flight to New York. Although the transportation on the return flight depends on the successful transportation on the outbound flight, the services on the return flight do not significantly affect the services on the outbound flight. In part, this is due to the fact that the airline can fulfill its promise to transport the passenger to Los Angeles independently of its promise to transport the passenger back to New York. In addition, because each flight is available from several alternate providers (that is, without involvement of the entity), the airline's promise to provide transportation back to New York is not necessary for the flight to Los Angeles to provide significant benefit to the customer. Therefore, because the flights do not significantly affect each other, they are not highly interrelated or highly interdependent. This results in the conclusion that, in this round trip example, the customer has purchased a contract or ticket in which the promise is for the airline to deliver each of the flights in the contract individually.

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<sup>1</sup> In previous version of the Audit and Accounting Guide, *Airlines*, *selling carrier* was referred to as *online (OL) carrier*.

10. Given the assessment of the factors included in FASB ASC 606-10-25-21(a)-(c) discussed in this section, FinREC believes that a round-trip ticket with two direct segments would generally represent two separate performance obligations.

*Ticket with Connecting Flights Operated by a Single Carrier*

11. In a ticket that includes a connecting flight operated by a single carrier (e.g. New York to Los Angeles that connects through Dallas), the nature of the overall promise to the passenger is generally to transfer the service of transportation from New York to Dallas and then Dallas to Los Angeles. The selling carrier has the obligation on both segments; however, the customer has made the choice to utilize the connecting flights based on his/her own considerations (which include knowledge of important factors such as the cost) versus a non-stop or alternative flight, if it was available. That is, the customer has elected this route over other possible routes, and has contracted with the selling carrier for both services in order to achieve the passenger's ultimate goal, which is to fly to Los Angeles. While the selling carrier has the obligation to complete both segments, and failure to fulfill this obligation to the passenger would likely result in the airline not being entitled to compensation for any portion of the partially completed contract, in practice, it is common that alternative arrangements would be made by the selling carrier in order to fulfill this obligation to the passenger. Although the transportation on the second segment depends on the successful transportation on the first segment, the customer can benefit from each flight on its own. The first segment has provided transportation for a portion of the journey and, therefore, once completed, has provided utility on its own for the customer's benefit. In addition, many times transportation on one segment is provided to transport a customer to an airline's hub or focus city where transportation to an increased amount of destinations or a particular destination is available hence creating true value and utility to the customer. In the preceding example, the connecting flight from Dallas to Los Angeles can be viewed as a readily available resource for the flight from New York to Dallas. In addition, each segment is likely available from several alternative providers and, therefore, the customer could have obtained transportation from multiple carriers indicating that each segment is capable of being distinct in accordance with FASB ASC 606-10-25-19(a). Also, because the carrier performs these services separately and independently related to each segment and, therefore, the segments are operationally independent, the segments do not significantly modify each other. Given the identified utility and operational independence of the two segments (that is, because the specified service of providing transportation from New York to Dallas can be fulfilled independently from the specified service to provide transportation from Dallas to Los Angeles without significantly affecting the customer's utility and/or ability to benefit from each specified service), the segments are not highly interdependent or highly interrelated. Therefore, in the single carrier connecting flight example, because of the operational independence of the two flights from each other, the two flights are each distinct within the context of the contract. Similarly, if a ticket included multiple connecting flights operated by a single carrier, each segment would be distinct within the context of the contract for the same reasons as discussed above.
12. Given the assessment of the factors included in FASB ASC 606-10-25-21(a)-(c) discussed in the preceding paragraph, FinREC believes that each segment in a ticket with connecting flights operated by a single carrier represents a separate performance obligation.

*Ticket with Connecting Flights Operated by Multiple Carriers<sup>2</sup>*

13. In a ticket with connecting flights operated by multiple carriers (e.g. New York to Dallas is operated by the selling carrier and Dallas to Los Angeles is operated by the OAL carrier), the selling carrier's nature of the overall promise is to transport the passenger in accordance with the contract for the portion of the trip that it is responsible for (e.g. New York to Dallas) and to arrange carriage on the OAL for the portion of the trip for which the OAL is responsible. In addition, for the connecting flight involving an OAL segment, the selling carrier is not providing a significant integration service under FASB ASC 606-10-25-21(a) of creating a combined item derived from services of the two segments as the two flights are independent of each other, the only integration is a coordination of the airline flight schedules (which the passenger can do without the knowledge and involvement of either airline) and connectivity for baggage, if applicable. More importantly, the passenger knows upfront that the selling carrier will only transport them from New York to Dallas and the OAL will transport them from Dallas to Los Angeles. Once the passenger arrives in Dallas and checks-in with the OAL for the flight to LA, then the OAL is fully responsible for operation of that segment, which is not dependent in any way on the earlier flight. Furthermore, the customer has made the choice to utilize two different airlines for transportation based on his/her own considerations (which include knowledge of important factors such as the cost) versus a non-stop or alternative flight. That is, the customer has elected this route over other possible routes. The first segment has provided transportation for a portion of the journey and, therefore, once completed, has provided utility on its own for the customer's benefit. In addition, many times transportation on one segment is provided to transport a customer to

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<sup>2</sup> References to "multiple carriers" in this paper do not include contract carriers (i.e., regional airlines), which will be addressed in Issue #2-1, *Regional Contracts*.

other airline's hub or focus city where transportation to an increased amount of destinations or a particular destination is available hence creating true value and utility to the customer. Given the identified utility and operational independence of the two segments (that is, because the specified service of providing transportation from New York to Dallas can be fulfilled independently from the specified service to provide transportation from Dallas to Los Angeles without significantly affecting the customer's utility and/or ability to benefit from each specified service), the segments are not highly interdependent or highly interrelated. An airline's contract of carriage may indicate that the selling carrier is acting solely as an agent of the OAL. Although the terms in the contract of carriage for codeshare flights are more complicated, the operating carrier contract generally governs operational areas, including irregular operations such as delays and cancellations. Regardless of the contract of carriage specifications, the customer has knowledge about what he/she is buying at the time of sale. Therefore, in the OAL connecting flight example, because neither carrier is providing a significant integration service to each other's flight segment, the operational independence of the two flights from each other, and the nature of the selling carrier's overall promise (which is to provide and arrange for two flights that the passenger can use to travel from New York to Los Angeles), the two flights are each distinct within the context of the contract. Similarly, if a ticket included multiple connecting flights operated by multiple carriers, each segment would be distinct within the context of the contract for the same reasons as discussed above.

14. Given the assessment discussed in the preceding paragraph, FinREC believes that in a ticket with connecting flights operated by multiple carriers, any segment operated by the selling carrier would generally represent a separate performance obligation; the selling carrier would also have a responsibility to arrange for the segments operated by the OAL.

*Revenue Accounting Issues - Classification of Interline Transactions (Principal versus Agent)*

15. Interline transactions in which the selling carrier sells a ticket to be operated by an interline partner would need to be evaluated under the principal versus agent criteria in paragraphs 36-37A of FASB ASC 606-10-55 which state:

55-36 When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

55-36A To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

- a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])
- b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

55-37 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

55-37A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- a. A good or another asset from the other party that it then transfers to the customer.
- b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
- c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

16. In paragraph BC382 in the Background Information and Basis for Conclusions section of ASU No. 2014-09 the FASB indicated the following:

The nature of the entity's promise may not always be readily apparent. For that reason, the Boards included indicators in paragraph 606-10-55-39 to help an entity determine whether the entity controls the goods or services before transferring them and thus whether the entity is a principal or an agent...

17. In paragraph BC16 in the Background Information and Basis for Conclusions section of ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606) - Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, the FASB further elaborated on the indicators in FAS ASC 606-10-55-39 as follows:

... The indicators (a) do not override the assessment of control, (b) should not be viewed in isolation, (c) do not constitute a separate or additional evaluation, and (d) should not be considered a checklist of criteria to be met in all scenarios. Considering one or more of the indicators often will be helpful, and, depending on the facts and circumstances, individual indicators will be more or less relevant or persuasive to the assessment of control.

18. FASB ASC 606-10-55-39 states:

Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

- a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
- b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
- c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.
- d. Subparagraph superseded by Accounting Standards Update No. 2016-08.
- e. Subparagraph superseded by Accounting Standards Update No. 2016-08.

19. FASB ASC 606-10-55-39A states:

The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

20. Therefore, the evaluation of the individual indicators requires judgment and will depend on the facts and circumstances prevalent in the particular industry and the particular types of transactions.

21. As the contract administrator, the selling carrier executes the contract with the customer; however, the OAL exclusively controls the operation of its flight segment. The selling carrier does not have control over the OAL segment - just the right to sell the OAL segment to a customer at agreed or published prices. If the customer does not fly on the OAL segment, the selling carrier does not have the right to resell or otherwise use the OAL segment, and the selling carrier does not have any obligation to pay the OAL for of the unused segment. Given that the OAL is responsible for its portion of the actual revenue producing element of the contract (i.e. transportation of the passenger) and the selling carrier's role as contract administrator, FinREC believes that the OAL controls the operation of its segment before the service is transferred to the customer. Furthermore, the three indicators that can be used to evaluate whether an entity is an agent or a principal are summarized in the following table and described in the subsequent paragraphs. From the selling carrier's perspective:

Scenario for selling carrier	Entity is primarily responsible for fulfilling promise	Entity has inventory risk	Entity has discretion in establishing prices
Interline	✗	✗	✓
✓ - Indicates that the selling carrier is the principal. ✗ - Indicates that the selling carrier is an agent.			

22. **The entity is primarily responsible for fulfilling the promise.** An airline’s contract of carriage may indicate that the selling carrier is acting solely as an agent of the OAL. Although the terms in the contract of carriage for codeshare flights are more complicated, the operating carrier contract generally governs operational areas, including irregular operations such as delays and cancellations. Regardless of the contract of carriage specifications, the customer has knowledge about what he/she is buying at the time of sale (e.g. that the outbound flight is operated by the selling carrier and the return flight is operated by the OAL). Furthermore, at the time of sale, the customer has an expectation related to the exact flight time and the operating carrier as specified in the ticket. Also, see the “Ticket with Connecting Flights Operated by Multiple Carriers” section of this paper. Therefore, in the context of this indicator, the OAL is responsible for fulfilling the promise of transportation for its segment.
23. **The entity has inventory risk.** In the context of the airline industry, inventory risk is the risk of unsold seats on flights. Inventory risk is equal for the selling and operating carrier at the time of sale, and neither party has taken on any risk for the other party as both have the option to make the inventory available at the time of sale based on sales price or, more specifically, allocation of the sales price under their code-share agreement. Furthermore, the selling carrier does not take on inventory risk related to segments flown by the OAL because its obligations to the OAL are established by the governing agreements at the time of the sale of the ticket that includes an OAL flight segment. If the ticket is cancelled or if the passenger does not fly an OAL flight segment, the selling carrier takes no responsibility to resell tickets for cancelled or not flown OAL segments and owes no consideration to the OAL for the cancellation (even in situations when the passenger does not fly OAL flight because of operational issues experienced by the selling carrier [e.g. selling carrier’s flight being late and, as a result, passenger misses the OAL flight]). Also, the selling carrier has no commitment to buy a certain number of seats on the OAL.
24. **The entity has discretion in establishing prices for the specified good or service.** The selling carrier does receive a commission that is designed to cover the proportional selling expenses it incurs in the transaction. However, the selling carrier often has discretion in establishing the selling price for the overall ticket, even though the financial benefit received from the OAL’s flight segment is usually contractually limited. The amount of money collected for tickets that include a segment flown by the selling carrier and a segment flown by an OAL carrier is allocated to the carriers based on specific agreements between carriers. The passenger has no knowledge of the financial arrangements between the selling and OAL carriers.
25. The benefit the selling carrier receives is limited because the airline either remits an agreed upon pro-rata share of the ticket price to the OAL, or the selling carrier retains only a commission percentage. However, even though the consideration payable from the selling carrier to the OAL is based on published fares for that segment, the selling carrier controls the total ticket price and, therefore, any pricing benefit or loss would be absorbed by the selling carrier as either an increase or reduction in the sales price of the segments that it operates.
26. Although the criteria in FASB ASC 606-10-55-39 are mixed with respect to whether the selling carrier is the principal or the agent in these transactions, FinREC believes that the predominant criteria carrying the most weight in the evaluation of this particular transaction in the airline industry is the operational control of the flights, which is the specified services in the contract with the customer. The OAL segment and operation is clearly controlled by the OAL and not the selling carrier, a factor which the passenger understands as part of the procurement process. The OAL flight uses the OAL aircraft and the OAL operates its flight using its own personnel and according to its own operating rules. The selling carrier has no role in operating the OAL aircraft or in directing OAL personnel and does not share in any of the cost or related margin of that flight. Therefore, the selling carrier would typically be considered an agent on behalf of the OAL for those flight segments operated by the OAL, although an entity would need to evaluate all relevant facts and circumstances in reaching a final conclusion in its situation. The selling carrier, as the agent, would recognize revenue for the selling price of the ticket net of the amount due to the OAL (the timing of revenue recognition for the OAL segment and its classification are not addressed in this paper and will be discussed in a separate paper). At the time of ticket sale, the total amount

received would be recorded by the selling carrier as a contract liability (referred to as air traffic liability or ATL), which includes the performance obligation that it has with respect to the segment that it will operate as well as the amount due to the OAL when the OAL satisfies its own performance obligation. Upon completion of flight on the OAL, the OAL satisfies its performance obligation for its segment and recognizes revenue for the gross amount of consideration to which it expects to be entitled in exchange for the flight service it provided. The selling carrier is the principal for the segment operated by the selling carrier and would recognize revenue gross for this performance obligation.

Comments should be received by June 1, 2017, and sent by electronic mail to Yelena Mishkevich at [yelena.mishkevich@aicpa-cima.com](mailto: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.

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