Working Draft:
Airlines Revenue Recognition Implementation Issue

Issue #2-6(a, d) - Brand Name and Customer List – Timing of Revenue Recognition.

Expected Overall Level of Impact to Industry Accounting:
Moderate

Wording to be Included in the Revenue Recognition Guide:

Introduction

1. As discussed in paragraph 1 of Issue #2.6(f), *Consideration of Significant Financing Component in Advance Mile Purchases and Miles in Customers' Accounts*, airlines with large loyalty programs frequently enter into agreements with a co-branded credit card partner in which mileage credits and other consideration (i.e. award travel, upgrades, bag fee waivers, lounge access, branding and marketing services, etc.) are sold to a financial institution, the mileage credits are then issued to the financial institution's credit card customers, who are also airline loyalty members, as they make purchases on their co-branded credit card. Frequently these co-branded agreements include upfront payments for advanced purchases of services under the co-branded contract (as described in Issue #2.6(f)). In these co-branded contracts certain services, principally advertising and branding, including access to the airline's customer list, are used directly by the financial institution. The services sold to the financial institution help its credit card business to obtain new and more profitable customers and promote increased spending on credit cards. Airline co-brand credit cards have historically been more profitable to the financial institutions than a typical credit card portfolio and, as such, they are willing to pay the airline for the access to their customers and brand of the airline. The term of these contracts generally ranges from five to seven years during which the financial institution is granted continual access to the customer list.

2. As discussed in paragraph 2 of Issue #2.6(f), co-brand agreements involve three parties and two customers from the airline's perspective. The parties to the agreements include an airline, a financial institution, and the credit card holder. The financial institution is the customer of the airline for the sale of marketing-related elements (including brand, customer list and advertising) that increase the value of its credit card portfolio. The credit card holder is the customer of the airline for the earning of mileage credits under its loyalty agreement (provided and paid for by the financial institution) into the loyalty member's account each time he or she uses the credit card based on a specified exchange rate. There are three contracts within co-brand agreements: 1) the airline and the credit card holder have a loyalty contract (i.e. the credit card holder must also be a loyalty member in order to obtain a co-branded credit card), 2) the financial institution and the airline are parties to the co-branded credit card contract, and 3) the financial institution and the credit card holder are parties to a credit contract. FASB ASC

606/Master Glossary defines contract as "[a]n agreement between two or more parties that creates enforceable rights and obligations." All of these agreements meet the definition of a contract and the criteria in FASB ASC 606-10-25-1 because they create enforceable obligations on the various parties.

3. As discussed in paragraph 3 of Issue #2.6(f), in the case of mileage credits sold by the airline to the financial institution, the mileage credits are ultimately awarded to the credit card holders, who are also airline loyalty members, based on their credit card purchases or other activities. Mileage credit awards are supplied by the airlines which also determine the range of goods and services for which the mileage credits can be redeemed as well as the number of mileage credit awards required to be redeemed for various awards in their programs. The credit card holder has no recourse to the financial institution but must look exclusively to the airline or the airline's loyalty program partners (see Issue #2-6(i), *Interline Transactions – Loyalty Payments*) for the satisfaction of the mileage credits obligation. Therefore, the nature of the promise by the airline with respect to mileage credits to be provided in a co-branded credit card agreement is the underlying goods or services for which the mileage credits may be used rather than the mileage credit itself.

4. The two most significant performance obligations in co-branded credit card arrangements are the sale of the mileage credits to the financial institution and the right granted by the airline to the financial institution to use its brand and customer list. (Paragraphs 1-6 of Issue #2-6(h), *Estimating Standalone Selling Price of Mileage Credits in Customer Loyalty Programs*, discuss why a mileage credit represents a separate performance obligation and the "Consideration of Whether the Brand and Customer List are Distinct Services" section of this paper addresses why the brand and customer list represent another performance obligation [referred to as the *brand performance obligation*].) Compensation for the two main performance obligations under the co-branded credit card agreements is paid at the time when a co-brand credit card is used by the loyalty member and coincides with when the financial institution collects its merchant fee on the transaction. As a result, the airline receives the vast majority of the consideration for the two main performance obligations as the co-brand credit card is used. The performance obligation related to mileage credits is satisfied at a point in time (generally when the related redemption occurs and the free or discounted services are provided to the loyalty customer) while the performance obligation(s) related to the brand elements, other marketing services and ancillary services is (are) satisfied over time. Therefore, the portion of the consideration attributable to the brand performance obligation is recognized over time (as the co-brand credit card is used) while the portion of the consideration attributable to the mileage credit is deferred until the point in time it is redeemed for goods or services.

Maintenance of Customer List Database

5. Under most co-branded credit card agreements, an airline is required to provide the financial institution throughout the term of the agreement with regular access to its loyalty program customer list and allow the use of its brand (the airline's name, logo, and so on). The first step in identifying performance obligations is to identify the goods or services promised in the contract. FASB ASC 606-10-25-16 states that

> …the promised goods or services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

6. In determining the appropriate accounting for the function of maintaining a customer list database, airlines should consider the guidance in FASB ASC 606-10-25-17, which states that

> Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contract with the customer.

7. Consistent with the guidance in FASB ASC 606-10-25-17, administrative tasks that an airline must undertake to fulfill a contract which do not transfer goods or services to the customer are not considered promised goods or services in the contract with the customer but rather fulfillment activities. This is due to the fact that a co-branded partner could not benefit from such service of maintaining and performing administrative tasks associated with the customer list. The task of maintaining and updating of the airline's frequent flyer database or member list is performed routinely by the airline regardless of whether the airline is a party to a co-branded agreement. FinREC believes that the promised service the airline is providing in such an arrangement is the access to the customer list and the use of brand name over the contract period which meets the requirements in FASB 606-10-25-19 (because the financial institution can benefit from the access to the customer list and the use of brand name and it is a distinct promise in the contract) and, therefore, represents a separate performance obligation. As discussed

in paragraph 17 of this paper, FinREC also believes that the combination of the brand name and customer list represents symbolic IP because it does not have significant stand-alone functionality, and substantially all of the benefits to the financial institution are derived from its access to the customer list and brand name which are supported by the airline's ongoing activities, including its ordinary business activities.

Consideration of Whether the Brand and Customer List are Distinct Services

8. FASB ASC 606-10-25-14 states that

    At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

    a. A good or service (or a bundle of goods or services) that is distinct

    b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

9. As discussed in the following paragraphs, in the airline co-brand credit card example, the use of the brand is not separable from the access to the airline's loyalty program customer list, which is used by the financial institution to target the airline's customers in order to solicit credit card business.

10. Generally, a significant portion of the value to the financial institution in these arrangements comes from its right to market to the airline loyalty members, which is provided through access to the airline's customer list. Frequently, the majority of the airline's most profitable customers are also members of the airline loyalty program. These members include many high-wealth individuals who have a better credit history and have higher levels of spending compared to the general population of credit card holders. As a result, a portfolio of credit cards with a shared demographic of airline loyalty memberships tends to be more profitable to the financial institution than a portfolio that is made up of individuals that are not part of an airline frequent flyer program. This is often one of the most important factors that leads to significant value being ascribed to these co-branded agreements. Additionally, strong brand recognition helps drive both new and repeat customer traffic to the airline, resulting in significant value associated with access to the airline's customer list.

11. When valuing the access to the customer list and use of the brand provided by the airline to the financial institution as part of a co-branded arrangement, airlines historically have used the relief from royalty method and do not separately distinguish between the value assigned to the customer list and brand name, thus, treating it as a single promised service. In a typical co-branded agreement, it is generally impractical to separate the value of the brand from the value associated with the access to the customer list.

12. Historically, airlines have not separately sold the right to use their brand and access their customer list outside of these types of arrangements. Although it is possible that these items could be sold separately, FinREC believes their integration into the co-branded credit card agreement generally meets the "highly interdependent or highly interrelated" criteria in FASB ASC 606-10-25-21(c). This is because the utility of the access to the customer list and use of the brand (and, therefore, the ability for each to provide value) are dependent upon each other. That is, the value of the two combined together significantly exceeds the sum of the value that could be ascribed to each individually.

13. Therefore, FinREC believes that the use of the airline brand and access to its customer list are not distinct and, as such, should be combined into a single performance obligation, subsequently referred to in this paper as the *brand performance obligation*. Access to the customer list and use of the brand are referred to as the *brand elements*.

Allocation of Consideration to the Brand Performance Obligation

14. FASB ASC 606-10-55-54 states that

    Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

    ….

    d. Patents, trademarks, and copyrights.

15. Consistent with the guidance in FASB ASC 606-10-55-54, FinREC believes that the right granted by the airline to the financial institution to use its brand elements as part of the co-branded credit card agreement qualifies as licensing of the airline's intellectual property (IP). The co-branded credit card partner uses the brand elements (including the airline's logo, on individual credit cards as well as in various marketing related materials) to help market the co-branded credit card. The use of the brand elements is beneficial to the financial institution due to association with the airline and its frequent flyer program customers.

16. As explained in FASB ASC 606-10-55-58, licenses of IP represent either a promise to provide a right to use an entity's IP, which is satisfied at a point in time, or a promise to provide a right to access the entity's IP, which is satisfied over time. Consistent with FASB ASC 606-10-55-58, the key consideration in determining the revenue recognition pattern is, whether the nature of the entity's promise in granting the license is to provide a customer with a right to access an entity's IP throughout the license term or a right to use an entity's IP as it exists at the point in time at which the license is granted.

17. When determining the nature of the entity's promise in granting the license to a customer, airlines should follow the guidance in paragraphs 59-63A of FASB ASC 606-10-55. FinREC believes that the combination of the brand name and customer list represents symbolic IP (which is described in FASB ASC 606-10-55-59(b)) because it does not have significant stand-alone functionality, and substantially all of the benefits to the financial institution are derived from its access to the customer list and brand name which are supported by the airline's ongoing activities, including its ordinary business activities. FASB ASC 606-10-55-60 provides that "a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time." Therefore, based on the guidance in paragraphs 58-58A of FASB ASC 606-10-55, consideration for symbolic IP should be recognized as revenue over the license period using a measure of progress that reflects the licensor's pattern of performance.

Revenue Recognition for Brand Performance Obligation

18. In addition to the brand performance obligation, co-branded arrangements include a separate performance obligation related to the sale of the mileage credits to the financial institution (which are issued to the airline's loyalty customers who then redeem them for travel and other services). The co-branded arrangement may also include separate performance obligations related to other marketing related services and/or the provision of ancillary services to the credit card holders (e.g., waived bag fees, priority boarding, lounge access). The performance obligation related to mileage credits is satisfied at a point in time (generally when the related redemption occurs and the free or discounted services are provided to the loyalty customer) while the performance obligation(s) related to the brand elements, other marketing services and ancillary services is (are) satisfied over time. FASB ASC 606-10-32-29 provides that "an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis." As a result, the airline would allocate the transaction price among the relative standalone selling prices of the brand performance obligation, marketing related services, ancillary services and the services expected to be provided upon the redemption of the mileage credits by the loyalty customers.

19. Substantially all of the consideration in co-branded credit card agreements is variable and a vast majority of the payments are based on a successful use of the card by the card holder. Paragraphs 5-9 of FASB ASC 606-10-32 provide guidance on estimating variable consideration and paragraphs 11-13 of FASB ASC 606-10-32 provide guidance on constraining estimates of variable consideration. FASB ASC 606-10-32-13 states that

    An entity shall apply paragraph 606-10-55-65 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of intellectual property.

20. As indicated in paragraph 15, the right granted by the airline to the financial institution to use its brand elements (that is, access to the customer list and use of the brand) as part of the co-branded credit card agreement qualifies as licensing of the airline's IP. When determining if the revenue recognition guidance in FASB ASC 606-10-55-65 is applicable to the IP in the arrangement, FASB ASC 606-10-55-65A states that

    The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

21. As a result, the airline would apply the guidance in FASB ASC 606-10-55-65 with respect to IP if it concludes that the aspect of the arrangement attributable to the licensing of the IP is the predominant item to which the royalty relates. This consideration would be based on the value of the IP element (that is, the combination of brand and customer list) to all other elements in the arrangement (which typically include other marketing related services, ancillary services and mileage credits). Significant judgment may be required to determine whether a license of IP is the predominant item in an arrangement. Value ascribed by the co-brand partner to the license of IP (that is, the combination of brand and customer list) relative to the other services to which the consideration relates (that is, other marketing related services, ancillary services and mileage credits) may vary depending on provisions embedded in co-brand arrangements between an airline and a financial institution. Based on facts and circumstances of individual co-brand arrangements, the airline may determine that the licensing of IP is the predominant item if it represents the major part or substantially all of the value of the arrangement to which the

consideration relates. If that conclusion is reached, then sales-based or usage-based royalty revenue method would be applied for revenue recognition, as discussed in the following section.

IP is considered the predominant item in the co-branded card arrangement

22. Once the transaction price is allocated between the performance obligations identified in the contract, then the airline should follow the guidance in FASB ASC 606-10-55-65, which provides that

    an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

    a. The subsequent sale or usage occurs.

    b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

23. In the co-branded arrangement, the promised services associated with the brand performance obligation are effectively provided to the financial institution each time the loyalty customer uses the co-branded credit card. This corresponds with the timing of when the airline issues or is obligated to issue the mileage credits to the loyalty customer in connection with the co-branded agreement. As a result, the airline would utilize usage of the co-brand credit card and related issuance of the mileage credits to determine the recognition of the sales-based and usage-based royalties. Therefore, consideration received in exchange for the brand performance obligation, would be recognized as revenue as and when the loyalty program members use their co-brand credit cards to make purchases and resulting mileage credits are issued to them under the-cobranded agreement.

<u>Minimums</u>

24. Co-branded arrangements frequently include a certain amount of guaranteed mileage credits to be sold, including amounts that are paid in advance (as described in Issue #2-6(f)). If the co-branded credit card agreement provides for a minimum amount of mileage credits to be sold (which may include a fixed amount of advance purchases), that minimum represents fixed consideration.

25. TRG Agenda ref 60, *November 2016 Meeting – Summary of Issues Discussed and Next Steps – Topic 2: Sales-Based or Usage-Based Royalty with Minimum Guarantee*,[1] provides three examples of reasonable ways to recognize revenue for a symbolic license of IP with a minimum guarantee:

    a) View A – If an entity expects total royalties will exceed the minimum guarantee, recognize revenue as the royalties (i.e. related sales) occur.

    (b) View B – Estimate the transaction price for the performance obligation (including fixed and variable consideration) and recognize revenue using an appropriate measure of progress, subject to the royalties constraint (in paragraph 606-10-55-65).

    (c) View C – Recognize the minimum guarantee (fixed consideration) using an appropriate measure of progress and recognize royalties only when cumulative royalties exceed the minimum guarantee.

26. However, as indicated in the TRG Agenda ref 60, TRG members acknowledged that there could be other acceptable approaches. Furthermore, TRG members observed that under any approach, the recognition must be in accordance with various aspects of FASB ASC 606. For example, under the selected approach, airlines will still need to consider the royalties recognition constraint in FASB ASC 606-10-55-65 and should not recognize revenue for variable amounts before the sales or usage occurs. Also, the TRG Agenda ref 60 indicates that the practical expedient in FASB ASC 606-10-55-18 is an appropriate method to measure progress if an entity has rights to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date. Furthermore, the selected approach should result in a recognition pattern that depicts an entity's performance in transferring control of goods or services promised to a customer in accordance with FASB ASC 606-10-25-31. The TRG Agenda ref 60 highlights other provisions of FASB ASC 606 that need to be considered and complied with when recognizing revenue for a license of symbolic IP.

<u>Royalty Rates</u>

27. Co-branded credit card agreements generally call for a fixed royalty rate over the term of the agreement (i.e., fixed amount of consideration per mileage credit issued to loyalty members as a result of their usage of a co-brand credit card). In this case, actual volume declines in number of mileage credits sold would be recognized as incurred as they would be reflective of the actual decline in the use of the IP. However, if the specified royalty rate

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[1] See TRG Agenda ref 60, *November 2016 Meeting – Summary of Issues Discussed and Next Steps* – Topic 2: Sales-Based or Usage-Based Royalty with Minimum Guarantee.

declines over time, an airline would need to evaluate whether the decline reflects the value transferred to the customer (that is, the financial institution). If the value transferred to the customer as it relates to the brand performance obligation is deemed to be constant but the royalty rate declines, then the declining royalty rate does not reflect the value transferred to the customer and an airline may have to defer revenue related to the brand performance obligation to properly allocate the revenue to the contract performance period.

IP is not considered the predominant item in the co-branded card arrangement

28. If the airline concludes that the IP element (that is, the combination of brand and customer list) is not the predominant item in the co-branded arrangement, then at contract inception, the airline should consider the guidance in paragraphs 5-9 of FASB ASC 606-10-32 on estimating variable consideration and the guidance in paragraphs 11-13 of FASB ASC 606-10-32 on constraining estimates of variable consideration. After considering variable consideration guidance, the airline should recognize revenue using one of the methods described in paragraphs 16-21 of FASB ASC 606-10-55.

Residual Approach

29. Under FASB ASC 606-10-32-34, an entity is allowed to use a reasonable estimation method, including the residual approach, as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs, and is applied on a consistent basis for similar goods and services and customers.

30. The residual approach is addressed in FASB ASC 606-10-32-34(c) which states

    An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:

    1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
    2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

31. The residual approach allows an entity that can estimate the standalone selling prices for one or more, but not all, of the promised goods or services to allocate the remainder of the transaction price, or the residual amount, to the goods or services for which it could not reasonably make an estimate.

32. With respect to valuation of the brand performance obligation under airline loyalty programs, FinREC believes that the use of the residual approach likely will be limited. The co-brand agreements are complex and include a number of different performance obligations (such other marketing related services, the provision of ancillary services to the credit card holders (e.g., waived bag fees, priority boarding, and lounge access), mileage credits and others) many of which generally do not have observable standalone selling prices as specified under FASB ASC 606-10-32-34(c) which is required for using the residual approach. Specifically, as described in Issue #2-6(h), mileage credits based on their nature do not generally have observable standalone selling prices.

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.