

Financial Reporting Center – Revenue Recognition

Working Draft: Airlines Revenue Recognition Implementation Issue



Issue #2-6(i) - Interline Transactions – Loyalty Payments

Expected Overall Level of Impact to Industry Accounting: Not Expected to Change Current Practice Except Potentially the Treatment of Revenue Related to Point Redemptions for Non-air Services and Products.

Wording to be Included in the Revenue Recognition Guide:

Accounting for Interline Mileage Credits – Gross versus Net Revenue Recognition

1. Many airlines have frequent flyer loyalty programs (FFPs) in which customers can earn miles, points, or segments (collectively referred to as *mileage credits*) through travel or purchasing other products or services. Airlines frequently include other airline partners in their FFPs to extend their programs in order to attract and retain certain premium passengers as well as to offer their FFP members extended options for the potential use of their accumulated mileage credits. In most of these cases, the airline also participates in the other airline's FFP on a reciprocal basis. Also, airlines sometimes offer their FFP members the ability to redeem mileage credits for non-air services or products from third-party providers (such as hotels, rental cars, and appliance sales companies). If the loyalty customer chooses the partner airline flight or a third-party product or service, the sponsoring airline will remit a contractually-agreed fee to the partner airline or third party for the flight, service or product. The question arises whether the airline is acting as a principal or agent when its loyalty customers redeem their mileage credits on partner airlines or for non-air travel services or goods from third-party providers and whether the related revenue and expense should be presented on a gross or net basis.
2. As discussed in paragraphs 1-6 in Issue #2-6(h), *Estimating Standalone Selling Price of Mileage Credits in Customer Loyalty Programs*, because mileage credits can be accumulated and redeemed for free or discounted goods and services (such as free travel, upgrades, and other awards), the mileage credits that have been accumulated represent a material right to customers. As a result, the airlines account for mileage credits separately as a performance obligation and defer revenue based on the estimated standalone selling price of the goods or services ultimately expected to be redeemed. However, as described in more detail in Issue #2-6(h), individual mileage credits do not represent a distinct good or service (that is, a mileage credit itself has no standalone value, its only value is based on the right as provided in the program to redeem an accumulation of mileage credits for free or discounted flight or other goods or services at some point in the future, based on the terms of the program at that time.)

3. Consistent with the guidance in FASB ASC 606-10-55-42, the portion of the transaction price allocated to a material right associated with mileage credits is initially deferred until the mileage credits are redeemed for goods or services. The value of the right is generally estimated based on the historical redemptions under the program. Accordingly, upon issuance, the airline records a contract liability for the mileage credits in accordance with FASB ASC 606-10-25-8 until the customer redeems them.
4. FASB ASC 606-10-55-36A provides that the assessment of principal versus agent criteria is based on assessment of who controls “each specified good or service before that good or service is transferred to the customer.” This assessment cannot be made at the time the mileage credit is issued, but would be made when the customer makes its choice upon redemption. It is at the time of redemption, when the selected service or product is known, that the airline evaluates whether it acts as an agent or principal in regard to the selected service or product. This is further supported by the following views expressed in paragraph BC385 of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*:

...the points may entitle customers to choose between future goods or services provided by either the entity or another party. The Boards observed that in those cases, to determine when the performance obligation is satisfied, the entity would need to consider the nature of its performance obligation. This is because until the customer has chosen the goods or services to be provided (and thus whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Thus, the entity may not satisfy its performance obligation until such time as it either delivers the goods or services or is no longer obliged to stand ready. The Boards also observed that if the customer subsequently chooses the goods or services from another party, the entity would need to consider whether it was acting as an agent and thus should recognise revenue for only a fee or commission that the entity received from providing the services to the customer and the third party.

5. If the airline concludes that it acted as a principal, it would record the payment as an operating expense. If the airline concludes that it acted as an agent, it would record the payment as an offset to revenue. In either case, the previously unrecognized revenue attributable to the issued mileage credits would be recognized.
6. At its March 30, 2015 meeting, the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) discussed the accounting for a customer’s exercise of a material right. TRG generally agreed that there are two supportable views regarding how to account for the exercise of a material right, which are described as follows:¹
 - View A:* At the time a customer exercises a material right, an entity should update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise. The additional consideration should be allocated to the performance obligation underlying the material right and should be recognized when or as the performance obligation underlying the material right is satisfied.

View B: The exercise of a material right should be accounted for as a contract modification. That is, the additional consideration received and/or the additional goods or services provided when a customer exercises a material right represent a change in the scope and/or price of a contract. An entity should apply the modification guidance in paragraphs 606-10-25-10 through 25-13 [18–21].

The TRG paper further indicates that

TRG members observed that in most, but not all, cases the financial reporting outcome of applying View A or View B would be similar. Only in cases in which the optional goods or services are determined to be not distinct from the original promised goods or services, would the results appear to differ. The staff thinks that an entity typically would conclude that an optional good or service is distinct. The method used to account for the exercise of a material right will depend on the facts and circumstances of the arrangement. TRG members agreed with the staff view that the method used should be applied consistently by an entity to similar types of material rights with similar facts and circumstances.

7. In the case of redemption of mileage credits, the customer does not pay any additional consideration but receives additional distinct services or goods. Therefore, FinREC believes that under either view, the accounting for the interline loyalty redemption would likely be similar.

¹ See [TRG Agenda ref 34, March 2015 Meeting – Summary of Issues Discussed and Next Steps](#) - Topic 2: Accounting for a customer’s exercise of a material right.

Redemptions on a Partner Airline - Principal versus Agent Analysis

8. At the time of redemption, if the customer chooses the partner airline (PA) flight, the sponsoring or home airline (HA) books the PA flight on the customer's behalf. The HA then pays the PA a contractually-agreed amount for the flight per the interline agreement. The PA effectively agrees at the time of ticketing (redemption of the mileage credits) to make the seat on its flight available at the rates specified in the interline loyalty agreement with HA. The HA would need to determine whether it acted as a principal or as an agent when it procured the PA flight on behalf of its loyalty member.
9. When performing the principal versus agent analysis, the airline should consider the guidance in paragraphs 36-40 of FASB ASC 606-10-55. Specifically, paragraphs 37 and 38 of FASB ASC 606-10-55, provide the following guidance

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.

55-38 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

10. Issue #2-5, *Interline Transactions – Identifying Performance Obligations for Air Travel (including at the Segment versus the Ticket Level) and Principal vs. Agent Considerations*, addresses the principal versus agent considerations when an airline sells a ticket that includes a segment to be operated by a PA. In Issue #2-5 it was concluded that the airline acts as an agent in regard to the PA segment. When the HA's loyalty customer redeems mileage credits for a PA flight, the principal versus agent analysis is the same as the analysis under Issue #2-5 because both issues involve the airline's arranging of a PA flight on behalf of its loyalty customer.
11. When considering guidance in FASB ASC 606-10-55-37, consistent with the conclusion reached in Issue #2-5, FinREC believes that the PA controls the specified good or service (i.e., transportation of the passenger) before that good or service is transferred to a customer. Furthermore, the HA does not control a right to the service to be performed by the PA as it is booking the flight simultaneously on PA, based on PA's availability, on behalf of the FFP member. FASB ASC 606-10-55-39 provides factors to consider when determining whether the airline acts as a principal or agent. See Issue #2-5 for the list and analysis of these factors, which is also applicable to this issue. The following is a brief summary of the factors from FASB ASC 606-10-55-39 and the conclusions reached in Issue #2-5.
 - a. *The entity is primarily responsible for fulfilling the promise to provide the specified good or service.* The analysis for this factor is the same as described in Issue #2-5 which concludes that the PA is primarily responsible for fulfilling the flight service.
 - 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).* The analysis for this factor is the same as described in Issue #2-5 which concludes that the HA does not have inventory risk.
 - c. *The entity has discretion in establishing the price for the specified good or service.* The analysis for this factor is the same as described in Issue #2-5 which concludes that the HA has latitude in establishing prices (that is, how many mileage credits are needed to redeem an award).
12. Issue #2-5 concludes that the selling airline would typically be considered an agent on behalf of the PA for those flight segments operated by the PA. Although the criteria in FASB ASC 606-10-55-39 are mixed with respect to whether the HA is the principal or the agent in transactions in which mileage credits are redeemed on PAs, consistent with the conclusion reached in Issue #2-5, FinREC believes that the FASB ASC 606-10-55-39 criterion carrying the most weight in the evaluation of these transactions is that the PA controls the flight and is primarily responsible for fulfilling the promise to provide the specified good or service from the time of ticketing forward. Accordingly, the HA would typically be considered an agent in regard to the PA flight and would record revenue and expense on a net basis. However, an entity would need to evaluate all relevant facts and circumstances in reaching a final conclusion.

Redemptions for Non-Air Services and Products - Principal versus Agent Analysis

13. In regard to a loyalty customer's redemption for non-air services and products from third-party providers, the airline would need to analyze the nature of its contractual relationship with the third-party provider to determine whether it acts as an agent or principal. As indicated previously, the timing of the analysis is upon redemption.
14. An airline may allow its FFP members to redeem mileage credits for a third-party service or product (such as a hotel stay, rental car, or appliance) through the airline's website or even directly with the third-party provider. Typically, the airline and the third-party provider have a contract that states the price the airline will pay for the hotel stay, car rental, or appliance. The airline is not obligated to purchase any hotel rooms or car rentals or appliances and will only make a purchase for the customer upon redemption of mileage credits. The third-party provider has primary responsibility for fulfilling the service, including making any reparations if the service or product is found to be unacceptable.
15. Under a typical program described in the preceding paragraph, FinREC believes that the airline would generally act as an agent because the service or product is never controlled by the airline prior to it being provided or shipped to the customer directly from the provider. In this case, the airline would record revenue and expense on a net basis. However, if the airline obtains control of the good or service in advance, it would record revenue and expense on a gross basis. The airline would need to evaluate its third-party contracts under the principal versus agent considerations in paragraphs 36-40 in FASB ASC 606-10-55 in order to make a gross versus net determination.

Revenue Characterization

16. When an airline acts as an agent in regard to its customers' mileage credit redemptions, FinREC believes the airline should recognize the net difference between the relieved liability associated with the mileage credits and the amount remitted to the partner airline or third-party provider as other revenue from contracts with customers.
17. When mileage credits are redeemed for a PA flight, if the customer requires any modifications to the ticket prior to the flight, depending on the circumstances or the nature of the change, those modifications would be executed by the sponsoring airline. Those modifications could involve arranging for service on a different PA or the sponsoring airline itself. Given the sponsoring airline's continued involvement prior to the PA fulfilling its promise of transportation, FinREC believes that the sponsoring airline's obligation to stand ready to deliver goods or services is not relieved until the flight date, at which point the sponsoring airline would recognize the net amount as other revenue from contracts with customers.
18. In the case of non-air redemptions, because the third-party provider has primary responsibility for fulfilling the service, including making any reparations if the service or product is found to be unacceptable, the net amount would be recognized as other revenue from contracts with customers at the date when the performance obligation is transferred to a third-party provider and the sponsoring airline is no longer obliged to stand ready to deliver goods or services (which would generally be the redemption date). This is consistent with the guidance in FASB ASC 606-10-55-40, which states that
If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (that is, the entity is no longer acting as the principal), the entity should not recognize revenue for that performance obligation. Instead, the entity should evaluate whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether the entity is acting as an agent).
19. When the award is redeemed by providing a flight on the sponsoring airline, the sponsoring airline acts as the principal in regard to its customers' mileage credit redemptions and records revenue and expense on a gross basis. In this case, FinREC believes it would be appropriate to characterize the related revenue as *passenger revenue*.

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.

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