July 1, 2016

Financial Reporting Center –
Revenue Recognition

Working Draft:

Airlines Revenue Recognition Implementation Issue

Issue #2.6(f) – Consideration of Significant Financing Component in Advance Mile Purchases and Miles in Customers' Accounts

Expected Overall Level of Impact to Industry Accounting: Moderate

Wording to be Included in the Revenue Recognition Guide:

Identified Customers in a Co-Branded Credit Card Agreement

1. Airlines with large loyalty programs frequently enter into agreements with a co-branded credit card partner in which miles 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 miles 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. Certain other services, principally advertising and branding, including access to the airlines customer list, are used directly by the financial institution. The services sold to the financial institution help their 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.

2. Co-brand agreements involve three parties and two customers from the airline's perspective. The parties to the agreement 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 deliverables, including brand, customer list and advertising elements that increase the value of its credit card portfolio. The credit card holder is the customer of the airline for the earning of points 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. 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 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 to which the mileage credits may be used rather than the mileage credit itself.

4. Under co-branded credit card agreements, the payments for various services (brand and advertising provided to the bank and points provided to the credit card holder) are generally made at the time the points are awarded to the customer accounts (except for advance mile purchases which are discussed in the following paragraphs). Payment is made to the airline exclusively by the financial institution. These payments generally include full consideration for selling all of the services provided to the financial institution and the loyalty member. At the time of the sale, the airline will allocate the revenue under the agreements to the bank and loyalty member/credit card holders and recognize revenue under the applicable recognition criteria.

Consideration of Financing Component in Relation to Advance Mile Purchases by Co-Branded Partner

5. Co-branded credit card agreements frequently include a provision that results in the advance purchase of miles. The financial institution is often willing to negotiate a cash payment upfront in order to obtain a lower purchase price for the miles. These agreements vary in form from the ones that simply advance miles to an airline's co-brand partner based on fixed dollar amounts to agreements that restrict the distribution of the advanced miles to co-brand customers until a future period as specified in the terms of the agreement. At the time of the advance, the miles are not available to be awarded into a customer's account, and the other services being delivered are not generally earned by the airline as future performance is still required. Advance mile purchases frequently exceed one year from the inception of the contract until the financial institution can issue the miles to the loyalty program member. Although some co-brand agreements require interest to be paid to the financial institution on the advance mile purchase, the vast majority of contracts do not require airlines to pay interest, thus resulting in a financial benefit to the airline from the advance purchases.

6. When an airline enters into a transaction for the advanced sale of a block of miles and the financial institution is prohibited from using or distributing those miles for a significant period of time, the first step in determining the proper accounting for such a transaction is to evaluate it under paragraphs 1-2 of FASB ASC 470-10-25. Specifically, the airline would need to determine whether, based on the terms of the arrangement, the advance represents, in substance, indebtedness of the airline. The existence of repayment terms, stated or implied interest rates, and/or the obligation to repurchase the prepaid airline miles by the airline at a later date may be indications that the advanced payment should be classified as indebtedness. If the advance qualifies as indebtedness, then the financing provisions of FASB ASC 606, *Revenue from Contracts with Customers,* are not applicable, and the advance is accounted for under FASB ASC 470-10 with imputation of interest performed in accordance with FASB ASC 835-30.

7. If the advance mile purchase does not qualify as indebtedness, then it is within the scope of FASB ASC 606. In this case, airline would follow guidance in paragraphs 15-20 of FASB ASC 606-10-32 to determine whether the contract has a significant financing component requiring imputation of interest in relation to the contract liability balance associated with the advance mile purchase.

8. FASB ASC 606-10-32-15 states that

   > In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

9. In assessing whether a contract contains a financing component and whether that financing component is significant to the contract, FASB ASC 606-10-32-16(a) provides that an entity should consider all relevant facts and circumstances, including "The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services." Given that typical co-branded credit card arrangements involve the sale of multiple deliverables, with frequently difficult to observe prices, and occur over multiple years, airlines' ability to reach a conclusion under FASB ASC 606-10-32-16(a) is likely to be limited. However, airlines are likely to conclude that there is a financing component under the guidance in FASB ASC 606-10-32-16(b), which requires considering

b. The combined effect of both of the following:

1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
2. The prevailing interest rates in the relevant market.

10. In the co-brand agreements in which a financial institution is not allowed to award airline miles for a significant period of time, a financing component would likely exist because the financial institution does not have control over the miles during the restricted period, while the airline has the benefit of utilizing the upfront cash receipt prior to having to perform on any obligations related to the advance. Because the terms of prepurchased mile agreements vary from entity to entity, the airline would need to carefully evaluate each transaction under the guidance in paragraphs 15-20 of FASB ASC 606-10-32 in order to arrive at the appropriate conclusion.

11. If the airline concludes that the prepurchase contains a significant financing component, the airline should consider the effects of the time value of money when determining the transaction price. A financing component will be recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). Entities should consider guidance outside the revenue standards to determine the appropriate accounting (i.e., FASB ASC 835-30, *Interest — Imputation of Interest*).

12. However, FASB ASC 606-10-32-18 provides a practical expedient under which

> an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

13. FinREC believes this practical expedient can be used for advances when an airline expects that advance will be used for purchases within one year from receiving the advance.

14. Entities may elect to forego the practical expedient and adjust consideration from the purchase of miles through calculation of a significant financing component for miles expected to be redeemed in a period of less than one year. The computation of the financing component is from the point of the advance until the miles are available to be issued by the co-brand partner to the customers. FASB ASC 606-10-32-17(a) states

> ….a contract with a customer would not have a significant financing component if any of the following factors exist:
>
> a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.

Therefore, the financing component is computed until the point in which the miles are available to the co-brand partner since the usage of the miles, at that point, is at the discretion of the customer (co-brand partner) to award the points to a loyalty member's account. Frequently this is the point in time when the miles are awarded to the loyalty account of a credit card holder. However, the ultimate determination of when the financing period is concluded is based on when the points are within the control of the co-brand partner and available to be issued or used. In most cases, there is not a significant time lag between when a co-brand partner has the right to use the advance purchase miles and when the miles are transferred from the co-brand partner to a credit card holder's account.

15. Furthermore, as was discussed by TRG during its March 30, 2015 meeting, FASB ASC 606 does not preclude an entity from deciding to account for a financing component that is not significant in the context of the contract.[1] An entity electing to apply the guidance on significant financing components for an insignificant financing should be consistent in its application to all similar contracts with similar circumstances.

Consideration of Financing Component in Relation to Customer Miles

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[1] See paragraph 35 in TRG Agenda ref 34, *March 2015 Meeting – Summary of Issues Discussed and Next Steps* - Topic 6: Significant financing components.

16. Airline passengers who are part of airline loyalty programs, and who travel on flights and/or use other products and services associated with airline business partners, accumulate miles in their member accounts as the miles are earned. The miles frequently will accumulate in the account holders' account for a period of time prior to being redeemed for loyalty program awards. Generally, time periods may range from approximately twelve months to in excess of three years between when miles are earned until when they are redeemed for awards.

17. When evaluating whether a significant financing component exists in relation to the liability associated with unused customer miles, airlines should consider guidance in FASB ASC 606-10-32-17(a), which is quoted in paragraph 14 of this paper.

18. BC233 in the "Basis for Conclusions" section of Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*,[2] further elaborates on guidance in FASB ASC 606-10-32-17(a) by stating that

    a. … The Boards noted that for some types of goods or services, such as prepaid phone cards and customer loyalty points, the customer will pay for those goods or services in advance and the transfer of those goods or services to the customer is at the customer's discretion. The Boards expected that, in those cases, the purpose of the payment terms is not related to a financing arrangement between the parties. In addition, the Boards decided that the costs of requiring an entity to account for the time value of money in these cases would outweigh any perceived benefit because the entity would need to continually estimate when the goods or services will transfer to the customer.

19. While an entity will have to evaluate whether a material right includes a significant financing component, there is likely not a significant financing component if the customer can choose when to exercise the option. In those circumstances, the airline's liability associated with unused miles in members' accounts would generally not be adjusted to consider a financing element. This is because, once awarded, those miles are subject to redemption at the discretion of the customer.

Comments should be received by September 1, 2016, and sent by electronic mail to Yelena Mishkevich at ymishkevich@aicpa.org, or you can send them by mail to Yelena Mishkevich, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.

[2] Paragraph BC233 and other paragraphs from the "Background Information and Basis for Conclusions" section of Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, were not codified in FASB ASC; however, FinREC believes this paragraph provides helpful guidance and, therefore, decided to incorporate it in this guide.