Working Draft:

Airlines Revenue Recognition Implementation Issue

Issue #2-6(h) - Estimating Standalone Selling Price of Mileage Credits in Customer Loyalty Programs

Expected Overall Level of Impact to Industry Accounting: Significant

Wording to be Included in the Revenue Recognition Guide:

Mileage Credits as a Material Right

1. Many airlines have frequent flyer loyalty programs in which customers can earn miles, points, or segments (collectively referred to as *mileage credits*) through travel or purchasing other products or services. The objective of the loyalty programs is to encourage higher levels of repeat business from airline customers. Airline loyalty program members are able to earn mileage credits by flying on a sponsoring airline and/or by flying on certain other participating airlines, such as those associated with an airline alliance partnership. Program members may also earn mileage credits through purchases from other non-airline partners such as credit card issuers, retail merchants, hotels, rental car companies, and various other promotional outlets. Once sufficient mileage credits have been accumulated, they may be redeemed by program members for free, discounted or upgraded air travel as well as other awards. In general, mileage credits provide an airline's customers with the option to acquire additional goods or services.

2. When accounting for mileage credits, airlines should follow guidance in FASB ASC 606-10-55-42, which states

   > If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

3. At its October 31, 2014 meeting, the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) discussed the types of factors that should be considered when evaluating whether a customer option to acquire additional goods or services provides a material right. Most TRG members agreed that the evaluation should consider relevant transactions with the customer (that is, current, past, and future transactions) and should

consider both quantitative and qualitative factors, including whether the right accumulates (for example, loyalty points).[1]

4. Also, in Example 52, *Customer Loyalty Program* (in paragraphs 353-356 of FASB ASC 606-10-55), FASB concluded that "[t]he points provide a material right to customers that they would not receive without entering into a contract…[and] the promise to provide points to the customer is a performance obligation."

5. Consistent with the preceding guidance in FASB ASC 606-10 and the TRG conclusion, since 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 a customer. Because the mileage credits represent a material right, they should be accounted for separately as a performance obligation. The concept of a material right as a performance obligation will also be addressed in Issue #2.6(c), *Loyalty Status*.

Determining Standalone Selling Price of Mileage Credits

6. Tickets sold to customers and miles sold to non-airline partners generally involve multiple performance obligations (identification of performance obligations will be addressed in separate papers). In FASB ASC 606/Master Glossary, a customer is defined as "A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." Each airline will need to identify its customers based on its specific facts and circumstances. Flying passengers, other airlines, and financial institutions are all examples of airline customers under FASB ASC 606.

7. Under the requirements in paragraphs 28-41 of FASB ASC 606-10-32, airlines should allocate the transaction price to each performance obligation identified in the contract (including mileage credit awards) on a relative standalone selling price basis. FASB ASC 606-10-32-33 indicates that if a standalone selling price is not directly observable, it should be estimated.

8. In applying a revenue model, airlines have concluded that a directly observable standalone selling price for the mileage credits is generally not available. Although mileage credits are sold under many types of arrangements, including those with co-branded credit card providers and other loyalty participants, these sales are either not standalone sales or sold in limited instances that may not represent a typical customer under FASB ASC 606. Mileage credit sales to co-branded credit card providers and other marketing partners are typically a part of bundled arrangements, which also include significant marketing, brand and other elements; therefore, these sales are not representative of a standalone selling price.

9. Airlines also sell mileage credits in direct transactions with customers; however, these sales are very limited in volume and availability (airlines generally limit such purchases to an amount less than what is required to redeem an award). The sales of miles directly to customers are generally used as an accommodation to a customer to reach a desired award redemption level. While in this situation, miles are sold on a standalone basis, these sales have historically been for a very limited volume of miles and contain other important restrictions, such that they have not been viewed as a reasonable indicator of the standalone selling price. Furthermore, the standalone selling price is based on a distinct good or service underlying each performance obligation. Individual mileage credits do not represent a distinct good or service; rather, it is the accumulation of mileage credits that results in an award redemption (e.g. a free flight or other good or service). As a result, the price for mileage credits that represents the product or service when the mileage credits are redeemed will generally need to be estimated as indicated in FASB ASC 606-10-55-44.

10. Airlines also sell mileage credits to partner airlines based on individual interline agreements, which is discussed further below.

11. FASB ASC 606-10-32-32 defines the standalone selling price as the price at which an entity would sell a promised good or service separately to a customer. FASB ASC 606-10-32-33 indicates that "[w]hen estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances."
12. FASB ASC 606-10-32-34 states that suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

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[1] See Topic 1 in TRG Agenda ref 11, *October 2014 Meeting – Summary of Issues Discussed and Next Steps* - Topic 1: Customer options for additional goods and services and nonrefundable upfront fees.

a. Adjusted market assessment approach
b. Expected cost plus a margin approach
c. Residual approach

13. The preceding methods are viewed as examples of suitable methods for estimating the standalone selling price (which are discussed in the following paragraphs). However, as indicated in paragraph BC268 of FASB ASU 2014-09,[2] "the Boards decided not to preclude or prescribe any particular method for estimating a standalone selling price so long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service if it were sold separately to the customer."

14. As indicated previously, when accounting for co-branded credit card arrangements under FASB ASC 606, airlines should estimate a standalone selling price of mileage credits. Certain historical approaches may be consistent with the objectives found in FASB ASC 606, and more specifically in paragraphs 28 and 33 of FASB ASC 606-10-32, which indicate that the objective is "to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer," and "[w]hen estimating a standalone selling price, ….an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances." Depending on specific facts and circumstances and information available, airlines have predominantly adopted one of two methods of estimation: 1) a stated or historical redemption value or 2) an equivalent ticket value (ETV). These methods resemble the adjusted market assessment approach, under which an entity evaluates the market in which it sells goods or services and estimates the price that a customer in that market would be willing to pay for those goods or services. As discussed in the following paragraphs, these methods may be used as a basis of estimating the standalone selling price of miles under the adjusted market assessment approach described in FASB ASC 606-10-32-34. However, there may be other methods an entity could consider to estimate the standalone selling price of mileage credits, which meet the objectives in paragraphs 28 and 33 of FASB ASC 606-10-32.

15. Regardless of the approach used to estimate the standalone selling price, these estimates would need to consider a fulfillment discount, which is an adjustment to reflect the likelihood of redemption. Mileage credits are issued in small amounts for each transaction, and it may take a passenger an extended period of time to accumulate a number of mileage credits required to earn an award. Ultimately, not every mileage credit issued or sold will be redeemed for an award due to 1) some airline policies which dictate that miles within member accounts expire after a specified period of account inactivity, and 2) the fact that members at airlines with no expiration policy for miles may never accumulate enough miles for an award redemption and, accordingly, will allow those miles to go unredeemed. According to guidance in FASB ASC 606-10-55-44, the estimate of the standalone selling price for a customer's option to acquire additional goods or services should reflect the discount that the customer would obtain when exercising the option, adjusted for, among other things, the likelihood that the option will be exercised. This concept is further illustrated in Example 52, *Customer Loyalty Program* (in paragraphs 353-356 of FASB ASC 606-10-55), in which the entity estimates a standalone selling price on the basis of the likelihood of redemption. Therefore, by using market inputs measured at the time of redemption, the airlines effectively include the likelihood of redemption (referred to as a *fulfillment discount*) in the estimated standalone selling price of a mileage credit.

Adjusted Market Assessment Approach

Redemption Value

16. The redemption value is often publicly available (either explicitly or implicitly) as part of loyalty redemptions and, therefore, utilized by many airlines to estimate selling prices of mileage credits. For example, some airlines allow a customer, when purchasing a ticket for travel, to toggle between the cash fare purchase price and the required number of mileage credits necessary to purchase such ticket, as part of the redemption process. This is referred to as a *redemption value* because the customer can determine the value being directly attributed to the actual mileage credits being redeemed. This is in contrast to mileage redemption models that have either one or only a few points of redemption prices (e.g. miles per award) and the underlying ticket prices are not directly correlated to the required number of mileage credits to be redeemed. However, in practice, the pricing models used to convert mileage credits to dollars would generally not involve a single stated value but a range of values based on market conditions (such as ticket type, time of day, market, etc.) To determine a redemption value to be applied,

[2] Paragraph BC268 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.

the airline would generally use a collection of values based on historical redemption values realized in its redemption transactions.

17. When estimating a redemption value, it is important to consider current market conditions, class of service, type of award, seasonality, as well as the time period in which the redemption data is accumulated.

18. To estimate a standalone selling price in accordance with the guidance in paragraphs 31-35 of FASB ASC 606-10-32, the redemption value also would need to be adjusted to reflect the likelihood of redemption, or fulfillment discount, to match the value at which an airline would sell mileage credits upon issuance of the miles to the customer's account, which is consistent with guidance in FASB ASC 606-10-55-44 and Example 52 on Customer Loyalty Programs (see earlier discussion about fulfillment discount).

19. FASB ASC 606-10-32-33 states that when estimating a standalone selling price, "…an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances." While FASB ASC 606-10-32-34 does not preclude or prescribe any particular method for estimating a standalone selling price so long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service if it were sold separately to the customer, FinREC believes that the Redemption Value method generally utilizes more observable inputs in determining standalone selling price than other estimation methods.

Equivalent Ticket Value

20. An equivalent ticket value (ETV) estimate of the standalone selling price of mileage credits is computed by using the average award fare for tickets, upgrades, or other loyalty awards similar to those redeemed within the airline's loyalty program divided by the average mileage credits redeemed to receive the award. ETV provides a reasonable approximation of the value of mileage credits and, therefore, their selling price, by reference to the value of the tickets, upgrades, or other loyalty awards that the airlines sell, matching those redeemed under the program.

21. When using ETV, an airline may refine the averages for both award fares and number of redeemed mileage credits used in the calculation, as well as assess the significance of other types of award redemptions. It may be helpful to consider factors such as redemption patterns, cabin class and geographic region of the awards. For example, the amount of the award fare can vary depending on market (domestic versus international travel) and time of year (seasonality). The amount of mileage credits redeemed can also vary based on class of service and seat availability. Both of these averages can change over time due to market conditions. Studies have shown that customers redeem mileage credits over several years, but generally, the majority is used within two to four years of issuance. When calculating ETV, it is important to consider the current market. If using historical data in the calculation, the time horizon of the data set would need to be long enough to mitigate the impact of short-term market volatility and seasonality and be representative of the current pricing environment. A period of less than one year would generally not achieve the desired objective.

22. In addition to including the estimated value of flights on the sponsoring airline, an ETV computation generally would include both the value for the redemptions historically occurring on other airlines (to the extent they occur within the population of historical redemptions) as well as the value of the redemptions settled for non-air products and services. These items, which historically have represented a smaller portion of the redemption population than awards settled for flights on the sponsoring airline, have generally been included at their redemption costs. Redemption costs are deemed to be appropriate because they represent the selling prices established by the airline's partners and has historically been representative of the prices available in the market for similar transactions.

23. To estimate a standalone selling price in accordance with the guidance in paragraphs 31-35 of FASB ASC 606-10-32, the ETV also would need to be adjusted to reflect the likelihood of redemption, or fulfillment discount, to match the value at which an airline would sell mileage credits upon issuance of the miles to the customer's account, which is consistent with guidance in FASB ASC 606-10-55-44 and Example 52 on Customer Loyalty Programs (in paragraphs 353-356 of FASB ASC 606-10-55). See earlier discussion about fulfillment discount.

Other Data

24. There may be other data or observable inputs, such as the transaction price of mileage credits sold between airlines or direct sales of miles to other parties, that might be considered in arriving at the estimated standalone selling price of a mileage credit.

Expected Cost Plus a Margin Approach versus Incremental Cost Method

25. According to FASB ASC 606-10-32-34(b), expected cost plus a margin approach is a suitable method for estimating the standalone selling price of a good or service. This approach is based on an entity's forecasting of its expected costs of satisfying a performance obligation and then adding an appropriate margin for that good or service. A cost-based estimate that incorporates fully allocated costs of providing the performance obligation to the customer, factors in an incremental profit margin and is appropriately adjusted to reflect the likelihood of redemption, may approximate a standalone selling price of a mileage credit and thus, is acceptable under FASB ASC 606. However, based on guidance in FASB ASC 606-10-32-33, when estimating a standalone selling price, airlines should consider all information that is reasonably available to them and maximize the use of observable inputs. Therefore, because observable inputs are often available, FinREC believes the expected cost plus a margin approach generally would not be used as the primary method of estimating the standalone selling price of a mileage credit but can be used as a way to corroborate the estimate determined using other methods.

26. Historically, there has been substantial industry practice to use the incremental cost method to account for airline customer loyalty programs. Under the incremental cost method, a liability is recorded for the incremental cost to the airline associated with providing flight awards to members for mileage credits that are expected to be redeemed. The incremental cost is not a fully loaded cost because it excludes substantially all fixed costs. FinREC believes that the incremental cost method is not a suitable method to estimate the standalone selling price under FASB ASC 606 because it is not a fully loaded cost plus a margin as required under the expected cost plus a margin approach described in FASB ASC 606-10-32-34(b).

Residual Approach

27. 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.

28. 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:
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> 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).
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> 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).

29. 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.

30. With respect to mileage credits under airline loyalty programs, FinREC believes that the use of the residual method likely will be limited due to the fact that many airlines have already established standalone selling prices or can reasonably estimate a standalone selling price for a majority of the performance obligations within airline loyalty programs. Additionally, as these agreements become more complex and include many more and varied performance obligations, such as to co-branded credit card agreements, the ability to use a residual approach is expected to be even more limited. However, if the residual method is used, FinREC believes that a calculated value of mileage credits near zero would not be appropriate.

Finance Cost Impact on Standalone Selling Price

31. An airline would need to consider the impact of financing in its evaluation of the standalone selling price of mileage credits. As discussed previously, mileage credits are redeemed over several years and, therefore, remain outstanding for more than one year. Consideration of an embedded finance cost is generally appropriate for assets and liabilities where realization is longer than one year. However, because mileage credit redemption is at the customer's discretion, an airline is not required to consider a financing cost as part of the mileage credit price. If the airline were to require certain redemption dates or otherwise restrict usage, consideration of an embedded finance cost would be necessary.

32. See Issue #2.6(f), *Consideration of Significant Financing Component in Advance Mile Purchases and Miles in Customers' Accounts*, for a more detailed discussion regarding the application of a finance cost under FASB ASC 606-10-32-17(a).

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.