

Technical Line

FASB – final guidance

How the new revenue standard affects airlines

In this issue:

Overview	1
Loyalty programs – mileage credits	2
Estimating standalone selling price	2
Principal versus agent considerations	3
Loyalty programs – status ..	3
Co-branding arrangements ..	4
Identification of performance obligations ..	5
Licenses of IP	5
Advance payments for mileage credits	6
Ticket performance obligations	6
Interline segments – principal versus agent considerations	7
Additional services and fees	7
Ancillary services	7
Change fees	8
Passenger ticket breakage ..	8
Ticket vouchers	8
Costs to obtain a contract ...	9
Capacity purchase arrangements	9
Appendix: The five-step revenue model and contract costs	11

What you need to know

- ▶ Airlines have had to change how they account for loyalty status benefits, mileage credits, change fees and “breakage” for tickets that expired unused.
- ▶ They also have had to make new disclosures. Airlines needed to make sure they have the appropriate systems, internal controls, policies and procedures in place to collect and disclose the required information.
- ▶ Many entities have found that implementation requires significantly more effort than they expected, including changes to their accounting processes and systems and/or internal controls.

Overview

The new revenue recognition standard¹ issued by the Financial Accounting Standards Board (FASB or Board) requires airlines to make additional judgments and estimates, such as which options provide material rights to customers.

This publication highlights key aspects of applying the FASB’s standard to an airline’s contracts with its customers, addresses significant changes to legacy practice and reflects the latest implementation insights.

As a reminder, the FASB deferred² the effective date to annual periods beginning after 15 December 2019 and interim periods in annual periods beginning after 15 December 2020, for entities that had not yet issued (or made available for issuance) financial statements that reflected the standard as of 3 June 2020 (i.e., certain private and not-for-profit entities).

Early adoption is permitted. The deferral is intended to give these entities more time to implement the standard, given the operational and financial reporting challenges of the COVID-19 pandemic. Public entities, as defined by the standard, and some private and not-for-profit entities were already required to adopt the standard.

This publication, which contains a summary of the standard in the Appendix, supplements our Financial reporting developments (FRD) publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it. The views we express in this publication may continue to evolve as implementation continues and additional issues are identified.

Airlines should also keep in mind that, when they adopt the new credit impairment standard,³ they will need to estimate full lifetime expected credit losses for their accounts receivable and contract assets. As a reminder, they will need to do this after assessing collectibility under the revenue guidance to determine whether they have a contract with a customer. Refer to our FRD publication, *Credit impairment for short-term receivables under ASC 326*, for more information.

Loyalty programs – mileage credits

Most airlines offer loyalty programs that allow customers to earn miles or points (referred to as mileage credits) for flying on the airline or using the services of one of its partners, such as a financial institution that issues co-branded credit cards, another airline, or a car rental or hotel company.

Under ASC 606-10-55-42, issuing mileage credits in loyalty programs generally provides a material right to customers that they would not receive without entering into a contract, and these credits should be identified as performance obligations for purposes of revenue recognition. This is because the customer effectively pays in advance for the right to obtain a future good or service (e.g., travel, upgrades, products) or a discount on that good or service. Airlines are required to allocate a portion of the transaction price to mileage credits and defer revenue recognition until the future good or service is provided or the mileage credits expire unused.

Estimating standalone selling price

Under Step 4 of the revenue model, the transaction price generally is allocated to the performance obligations in a contract based on their relative standalone selling prices. Although airlines sell mileage credits, these sales are either not standalone sales (e.g., sales to co-branded credit card partners) or they are sold in limited instances (e.g., sales of “top-off miles” to a customer so they can reach a desired award redemption). Therefore, these sales may not be viewed as a reasonable indicator of the standalone selling price of a mileage credit.

Because airlines generally do not have observable standalone selling prices for mileage credits, they have to make an estimate considering all reasonably available information, using a method that maximizes observable inputs. They also have to apply that method consistently.

While the standard discusses three estimation approaches, we believe that airlines are likely to conclude that the adjusted market assessment approach maximizes observable inputs. (The other two approaches discussed in the standard are the “expected cost plus a margin” approach and a residual approach.)

The adjusted market assessment approach focuses on the amount an entity believes a buyer in the market in which it sells goods or services is willing to pay for a good or service. We expect most airlines to use the redemption value method or the equivalent ticket value method to apply this approach. The redemption value method bases the estimate on the price of tickets stated both in mileage credits and in cash. For example, if the airline accepts either dollars or mileage credits as payment for tickets, the implied conversion rate would be the redemption rate. The equivalent ticket value method uses the average historical price of tickets, upgrades

Airlines may have determined that their current valuation model for mileage credits was not appropriate under the new standard.

or other goods or services similar to those redeemed in the airline's loyalty program, divided by the average mileage credits redeemed to receive the awards. Regardless of which method an airline uses, the airline needs to reduce the estimate to reflect the likelihood that some mileage credits will not be redeemed (i.e., breakage).

How we see it

Deferring a portion of the ticket price for mileage credits has been a change in practice for airlines that used the incremental cost method to account for mileage credits under legacy GAAP. Under the incremental cost method, airlines did not defer revenue but instead recorded a liability for the cost of providing future goods or services to the customer. Given that many of an airline's costs are fixed, this liability was significantly lower than the standalone selling price of a mileage credit.

Airlines that deferred revenue for mileage credits under legacy GAAP (either those provided through co-branded arrangements or earned through ticket purchases) have had to determine whether their method of estimating the standalone selling price of mileage credits under legacy guidance was appropriate under the new revenue standard. For example, airlines that used the equivalent ticket value method under legacy GAAP might have determined that the redemption value method, if applicable based on the structure of the airline's program, is more appropriate because it maximizes observable inputs.

An airline might consider the price it charges another airline for mileage credits in its estimate. However, these transaction prices generally are not considered observable selling prices for other customers because airlines don't sell mileage credits to other customers at these prices.

Principal versus agent considerations

Many airlines allow loyalty program members to redeem mileage credits for goods or services provided by a partner (e.g., travel on another airline, hotel stays). The nature of the airline's performance obligation is not known until the customer redeems the mileage credits. That is, until the customer chooses the goods or services (and thus determines whether the airline or a third party will provide those goods or services) or the miles expire, the airline is obliged to stand ready to deliver goods or services.

Third-party travel redemptions are discussed in the *Interline segments – principal versus agent considerations* section below. For other third-party redemptions, the airline must determine whether it controls a promised good or service before transferring that good or service to the customer using the guidance in ASC 606-10-55-36 through 55-40. The FASB explained⁴ that, if the customer chooses to redeem mileage credits for goods or services from another party, the entity would need to consider whether it was acting as an agent, and if so, the entity would recognize revenue for only a fee or commission that it received for arranging the ultimate transaction between the customer and the third party.

If the customer chooses to receive the goods or services from the airline, the airline is acting as a principal in the transaction and recognizes revenue on a gross basis when it satisfies its performance obligation by completing the flight.

Loyalty programs – status

Many airlines have programs that allow customers to earn loyalty status based on the achievement of defined metrics (e.g., miles flown, trips flown, dollars spent) during a specified period, typically one year. These points have no redemption value, and, unlike mileage credits, they cannot be exchanged for an award. Instead, they are a tracking mechanism to measure a

customer's progress toward qualification for loyalty status. Depending on the level of status a customer achieves, the airline may provide free or discounted services, such as waived baggage fees, priority boarding, seating upgrades or airport lounge access.

An airline has to determine whether a contract with a customer (i.e., a ticket for travel) includes a material right to receive these types of benefits under its loyalty status program. To do this, airlines have to determine whether the rights provided to customers at each status level exist independently of past ticket contracts. If the status benefits exist independently, they are considered marketing incentives rather than performance obligations. However, if they do not exist independently, they are material rights and, therefore, separate performance obligations.

To demonstrate that status benefits are a marketing incentive, an airline should consider whether it provides loyalty status to individuals who have not made purchases. Possible examples of marketing incentives include providing loyalty status (1) to members of another airline's loyalty status program (e.g., providing equivalent, or "matching," status based on what a customer earned with another airline), (2) to customers temporarily because an airline anticipates that the customer will meet the status requirements or (3) through marketing affiliation agreements (e.g., loyalty status awarded to hotel chain customers) for which the airline is not compensated.

Determining whether status benefits are marketing incentives or material rights requires significant judgment and may depend on how often the benefits are conferred. If an airline doesn't frequently provide status benefits for reasons other than past purchases or if certain indicators exist (e.g., loyalty status is sold for cash, the customer can transfer the loyalty status), the loyalty status is likely a material right that must be accounted for as a performance obligation.

Airlines have had to use significant judgment in determining whether loyalty status benefits are material rights.

How we see it

Airlines have to analyze the facts and circumstances of their loyalty status programs to determine whether the benefits they offer program members constitute material rights. Because the analysis has to be done for each status level, an airline could conclude that the benefits offered in the lower-status tiers are marketing incentives but those offered in higher-level status tiers are material rights.

Co-branding arrangements

Airlines often partner with financial institutions in co-branded credit card arrangements. In this type of agreement, an airline typically provides the financial institution access to the airline's loyalty program customer list and a license to use the airline's brand in marketing the co-branded credit card. The airline also sells mileage credits and other services (e.g., upgrades, waived baggage fees, lounge access) to the financial institution, which awards them to its customers (i.e., holders of the co-branded credit card).

The primary contract consideration the airline receives is generally variable and is based on the number of mileage credits sold to the financial institution, which usually equals the number of mileage credits earned by credit card holders. An airline may determine that both the credit card holder and the financial institution are customers of the airline in the arrangement. This may be the case if the airline believes it is promising to transfer goods or services to both the credit card holder (e.g., maintaining the loyalty program and offering goods and services to credit card holders who collect enough mileage credits) and the financial institution (e.g., providing access to the customer list and the license to use the airline's brand).

Identification of performance obligations

An airline must determine which of the promised goods and services in its contract with a financial institution to account for as separate performance obligations. Because mileage credits can be accumulated and redeemed for free or discounted goods and services, a mileage credit an airline sells to a financial institution generally would represent a material right to a customer and should be accounted for separately as a performance obligation.

Other services provided to the co-branded credit card holders (e.g., upgrades, waived baggage fees, lounge access) or to the financial institution (e.g., license of its brand, access to its customer list and marketing services) also may represent performance obligations. Access to the airline's customer list and use of the airline's brand generally would be combined into a single performance obligation (i.e., the brand bundle) if those individual promises are not separately identifiable. For example, if access to the airline's customer list and the use of its brand significantly affect each other, the airline may determine that these items should be accounted for as a single performance obligation.

Most co-branded credit card arrangements allow the financial institution to access the airline's customer list during the contract term and include a promise that the airline will keep that customer list up to date. Because the maintenance of the customer list significantly affects the utility of the financial institution's access to the list (which is included in the brand bundle discussed above), the promise to maintain the list is not distinct and does not represent a separate performance obligation.

Once an entity identifies the performance obligations in a co-branded credit card arrangement and determines the transaction price, the entity must allocate the transaction price to the performance obligations generally in proportion to their standalone selling prices and recognize revenue when (or as) each performance obligation is satisfied.

Licenses of IP

Because the brand bundle includes a license of intellectual property (IP), an airline has to consider the licenses guidance in ASC 606-10-55-54 through 55-65B when determining the nature of its overall promise to the customer and whether that promise is satisfied over time or at a point in time. Because the license for the brand within the brand bundle does not have significant standalone functionality and substantially all of its utility is derived from the financial institution's association with the airline's past or ongoing activities (including ordinary business activities to support its brand and customer list), an airline may determine revenue should be recognized over time for the brand bundle that contains the license to symbolic IP.

Because the majority of the consideration under the contract is variable and is payable when the financial institution purchases the mileage credits (which usually occurs when credit card holders earn mileage credits), the airline considers the financial institution's payment for mileage credits a usage-based royalty. To determine whether the guidance for usage-based royalties in ASC 606-10-55-65 applies, the airline must determine whether the brand bundle that contains the license of IP is the predominant item in the contract to which the royalty relates.

For the brand bundle to be the predominant item, the airline should have a reasonable expectation that the financial institution would ascribe significantly more value to it than to the other goods or services in the contract (e.g., travel provided upon redemption of the mileage credits, marketing services, ancillary services). If the brand bundle is determined to be predominant, the airline recognizes the royalties as revenue at the later of when the usage occurs or the performance obligation has been satisfied (the royalty recognition constraint).⁵ However, for a license of symbolic IP with a minimum guarantee (e.g., a co-branded agreement that requires either a minimum purchase of mileage credits or a nonrefundable advance payment for mileage credits), various recognition approaches could be acceptable.⁶

If an airline determines that the brand bundle is not the predominant item to which the royalty relates, the airline must estimate the transaction price (including consideration of the constraint) and determine the measure of progress that faithfully depicts its performance related to the brand bundle performance obligation, which is satisfied over time. Appropriate methods to measure progress toward complete satisfaction of a performance obligation include output methods and input methods. When determining the appropriate method for measuring progress, an entity considers the nature of the good or service it promised to transfer to the customer.

Advance payments for mileage credits

Some co-branding arrangements include provisions for the financial institution to purchase a pool of mileage credits. These agreements often restrict the distribution of the mileage credits by the financial institution until a future period. Some of them also require the airline to pay interest on the advance payment.

To account for these transactions, an airline needs to determine whether, based on the terms of the arrangement, the financial institution's advance payment for mileage credits represents, in substance, debt of the airline. The existence of repayment terms, stated or implied interest rates and/or the obligation to repurchase the mileage credits at a later date may indicate that the advance payment from the financial institution should be classified as debt. If that's the case, the advance is not within the scope of the revenue standard. Instead, it is accounted for under ASC 470-10, *Debt – Overall*, with imputation of interest calculated in accordance with ASC 835-30, *Interest – Imputation of Interest*.

If the advance payment does not qualify as debt, it is within the scope of the revenue standard, and the airline must assess whether the contract contains a significant financing component in accordance with ASC 606-10-32-15 through 32-20. The FASB's objective⁷ in requiring entities to adjust the promised amount of consideration for the effects of a significant financing component was for entities to recognize as revenue the "cash selling price" of the underlying goods or services at the time of transfer.

If the financial institution is restricted from awarding the mileage credits for a period of more than one year, a financing component likely exists because the financial institution does not have control over the mileage credits during the restricted period (i.e., delivery of the miles effectively has not occurred) and the airline has the benefit of using the cash before performing its obligations. The airline also must assess whether any financing component is significant to the contract. Because the terms of advance payments for mileage credits vary from contract to contract, airlines need to carefully evaluate each transaction.

How we see it

Accounting for co-branded credit card arrangements is complex and requires judgment. Under the new standard, the pattern of revenue recognition may differ from what an airline recorded under legacy guidance.

Ticket performance obligations

Travel to an airline customer's destination may include multiple flight segments (i.e., connecting flights), including segments provided by other airlines under agreements to provide transportation interchangeably between the carriers. These segments are referred to as interline segments.

To apply the standard, airlines must analyze the segments in a ticket to identify the performance obligations. When purchasing an airline ticket, customers have the option to choose, based on their preferences, from multiple itineraries that may include nonstop flights or multiple connecting segments with varying lengths of time between connecting segments. Each segment

Airlines that have co-branding agreements have to assess whether the brand bundle is the predominant item to which the mileage credit royalty relates.

is capable of being distinct (because segments are frequently sold separately) and is separately identifiable (because the two segments both do not significantly modify each other and are not highly interrelated or interdependent). That is, the airline can fulfill its promise to provide one segment independently of the other segment. Therefore, each segment generally is distinct and is a separate performance obligation.

Interline segments – principal versus agent considerations

When an airline sells a ticket that includes an interline segment, the selling airline must determine whether it is the principal or an agent in the delivery of the interline segment flight. Under ASC 606-10-55-36A, a selling airline needs to consider whether it controls the delivery of the interline segment (i.e., the specified service) before the service is transferred to the customer.

Although airlines must consider the unique facts and circumstances of their interline agreements, the selling airline generally is considered an agent in an interline segment transaction. That's because the selling airline does not operate the interline segment and does not have the ability to direct the use of the flight to another customer (e.g., if the passenger does not take the flight, the selling airline cannot resell the right to take that flight to another customer). The selling airline also may consider the indicators in ASC 606-10-55-39 that an entity controls the specified good or service before it is transferred to the customer. Although the selling airline has discretion in establishing the price for the overall ticket, the amount payable to the operating airline is fixed, and the selling airline would absorb any increase or decrease in the overall ticket price. The operating airline is responsible for fulfilling the promise of transportation for the interline segment, is paid only if the passenger takes the flight and has the inventory risk if the ticket is canceled or exchanged prior to departure. As an agent, the selling airline has to consider the timing of recognition for the commission it earns for the agency service.

As the principal in the operation of the interline segment, the operating airline records revenue on a gross basis in passenger revenue and recognizes an expense for the commission the selling airline takes.

Additional services and fees

Ancillary services

Airlines may charge fees for ancillary products or services that can be purchased at the time of ticket purchase, at the airport or during flight (e.g., baggage service, seat assignment, priority boarding, food, entertainment). Ancillary services generally are not capable of being distinct. This is because the ancillary goods or services must be consumed or delivered concurrently or in conjunction with the flight, and a customer cannot separately benefit from such goods and services without the flight.

Generally, the purchase of ancillary services represents a contract modification because the scope and price of the contract are modified. However, because the ancillary services described above are not distinct, they are combined with the existing performance obligation(s) and accounted for as if they were part of the original ticket. That is, the original consideration estimated for the ticket and the ancillary fee are combined and allocated to the new ticket performance obligation(s) and recognized when performance is complete (i.e., travel occurs).

Some ancillary services, such as the purchase of airport lounge access, may be considered distinct because the customer can benefit from the services without the purchase of a ticket. Such fees should be recognized in revenue when or as the future service is provided.

Presenting ancillary fees in passenger revenue affects key metrics.

How we see it

Under the standard, airlines recognize most ancillary fees at the time of travel, but the presentation of these fees on the income statement changed from legacy presentation. Ancillary fees are recognized in passenger revenue (along with ticket revenue), rather than in other revenue, where they generally were recognized under legacy guidance. Because this change affects key metrics, such as passenger revenue per available seat mile and yield, airlines should explain the change to investors and other stakeholders.

Airlines may present the components of revenue from contracts with customers either in the income statement or the footnotes.

Change fees

Airlines often charge customers to make changes to nonrefundable tickets. Because no additional goods or services are transferred to the customer, the process of changing the customer's itinerary generally is considered an administrative task that doesn't create a separate performance obligation. Instead, changing a customer's itinerary is a contract modification. Because the modification generally does not qualify to be accounted for as a separate contract under ASC 606-10-25-12, the change is accounted for as if it were a part of the original ticket and combined with the existing performance obligation(s). That is, the original consideration estimated for the ticket and the change fee are combined and allocated to the new ticket performance obligation(s) and recognized when (or as) performance is complete (i.e., travel occurs).

How we see it

The timing of recognition of these fees and their presentation in the income statement both differ from practice under legacy GAAP. Under the new standard, change fees are recognized in passenger revenue at the time of travel rather than in other revenue when the change occurs, as airlines generally did under legacy guidance.

Passenger ticket breakage

As tickets for travel are purchased by passengers, the consideration allocated to the travel performance obligation(s) is recorded as a contract liability (generally referred to as an air traffic liability) and recognized in revenue once the passenger has flown and the travel performance obligation is satisfied. Tickets that expire unused represent unexercised passenger rights, referred to as passenger ticket breakage.

Because airlines expect to be entitled to some amount of revenue from breakage, they recognize breakage amounts as revenue in proportion to the pattern of rights exercised by the customer considering the constraint on variable consideration in accordance with ASC 606-10-55-46 through 55-49. Airlines may use the practical expedient in ASC 606-10-10-4 to recognize breakage for a portfolio of flight performance obligations if they reasonably expect that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual flight performance obligations within that portfolio.

Ticket vouchers

Many airlines issue travel vouchers as an enticement to accept a voluntary change (e.g., take a later flight when the scheduled flight is overbooked).

In this instance, the issuance of a travel voucher generally is considered a contract modification. Because the price of the contract does not increase for the additional services offered through the voucher, the issuance of the voucher would not be accounted for as a separate contract under ASC 606-10-25-12. Therefore, the transaction is considered the termination of the existing contract (i.e., the original ticket) and the creation of a new contract under ASC 606-10-25-13(a) with (at least) two performance obligations, the segment(s) in the new ticket and the travel voucher. The consideration received for the original ticket is allocated between the new flight segment(s) provided and the ticket voucher, based on their relative standalone selling prices. The standalone selling price for the voucher includes an estimate of the likelihood that some vouchers will not be redeemed.

Costs to obtain a contract

Under the cost guidance in ASC 340-40,⁸ the incremental costs of obtaining a contract (i.e., costs incurred to obtain a contract that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them (either through direct reimbursement or margin inherent in the contract). As a practical expedient, ASC 340-40-25-4 permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing such costs would have been amortized in one year or less.

For airlines, costs to obtain a passenger ticket contract typically include credit card fees, global distribution system fees, and travel agency and other commissions. As discussed above, tickets often contain multiple performance obligations. Because the costs to obtain the contract are the same regardless of whether there are other performance obligations (e.g., mileage credits, loyalty status benefits), the costs may be allocated to the travel performance obligations. Costs to obtain the ticket contract (if allocated to the travel performance obligations) generally qualify for the practical expedient because tickets are usually sold less than a year in advance.

How we see it

An airline must consistently apply the method it selects to account for costs to obtain a ticket contract. This may be a change for airlines that capitalized some costs but expensed others under legacy GAAP.

Capacity purchase arrangements

Under a capacity purchase agreement, a regional airline operates flights on behalf of a major airline. The major airline sets the flight schedules, establishes fares, sells tickets and manages the seat inventory. The regional airline provides the aircraft (and frequently its maintenance), the pilot and the crew. The agreement may require the regional airline to provide other services, including ground services (e.g., baggage handling, gate personnel), the provision of fuel and use of its terminal facilities, and the regional airline may perform these services for all flights in and out of certain airports, including those operated by the major airline.

A regional airline must first analyze the arrangement to determine whether it contains a lease of the aircraft or terminal facilities under ASC 840, *Leases*, or under ASC 842, *Leases*, once it adopts that new standard.⁹ If the arrangement contains a lease and also includes non-lease goods or services (e.g., flight services), both ASC 840 and ASC 842 require the regional airline (i.e., the lessor) to allocate consideration in the contract between lease(s) and non-lease goods and services on a relative standalone selling price basis, except when allocating certain discounts and variable consideration.¹⁰ Any non-lease goods or services are in the scope of the revenue standard, and the regional airline must evaluate the related promises to determine which are distinct and are, therefore, separate performance obligations.

The accounting for capacity purchase arrangements is complex and requires judgment.

Because multiple goods and/or services are included in a capacity purchase arrangement, regional airlines are likely to have multiple performance obligations. Although regional airlines must analyze the facts and circumstances of their agreements, capacity purchase arrangements generally include promises for flight services, ground services and providing fuel that should be evaluated to determine whether they are distinct. An airline also must determine whether any of the performance obligations identified represent a promise to transfer to the major airline a series of distinct goods or services that are substantially the same and have the same pattern of transfer.

If another party is involved in providing a specified service (e.g., providing fuel to the major airline), the regional airline also needs to determine whether the nature of its promise is to provide the specified service itself (i.e., the regional airline is a principal) or to arrange for another party to provide that good or service (i.e., the regional airline is an agent).

Endnotes:

- ¹ Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, and created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.
- ² ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*.
- ³ ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.
- ⁴ Paragraph BC385 of ASU 2014-09.
- ⁵ Because the royalty recognition constraint must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP, an airline may not recognize revenue for other performance obligations (e.g., upgrades, waived baggage fees, lounge access) unless the uncertainty is resolved (i.e., the mileage credit is sold). Once the mileage credit is sold, then the airline will allocate consideration to the other performance obligations and recognize revenue as those performance obligations are satisfied.
- ⁶ 7 November 2016 FASB Transition Resource Group for Revenue Recognition (TRG) meeting; agenda paper no. 58. Also see Question 8-8 in section 8.5 of our FRD publication, *Revenue from contracts with customers (ASC 606)*.
- ⁷ Paragraph BC230 of ASU 2014-09.
- ⁸ ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, was created by ASU 2014-09.
- ⁹ Regional airlines have to apply ASC 840 or ASC 842, once adopted, to determine what is related to the lease element/component. For example, under ASC 840, lease-related executory costs (e.g., insurance, maintenance, taxes) are considered part of the lease element when lease and non-lease elements are separated. Under ASC 842, payments for maintenance activities are considered non-lease components, and items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., insurance, taxes) are not considered separate lease or non-lease components.
- ¹⁰ ASC 842, once adopted, provides a practical expedient that allows lessors to elect, by class of underlying asset, to not separate non-lease components from the associated lease components when certain criteria are met. Refer to our FRD publication, *Lease accounting: Accounting Standards Codification 842, Leases*, for more information.

Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer
<p>Definition of a contract</p> <p>An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:</p> <ul style="list-style-type: none"> ▶ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations. ▶ The entity can identify each party's rights regarding the goods or services to be transferred. ▶ The entity can identify the payment terms for the goods or services to be transferred. ▶ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract). ▶ It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. <p>If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.</p> <p>Contract combination</p> <p>The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:</p> <ul style="list-style-type: none"> ▶ The contracts are negotiated as a package with a single commercial objective. ▶ The amount of consideration to be paid in one contract depends on the price or performance of another contract. ▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation. <p>Contract modifications</p> <p>A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:</p> <ul style="list-style-type: none"> ▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract. ▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract. ▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

Step 2: Identify the performance obligation(s) in the contract

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- ▶ The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct).
- ▶ The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract).

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted.
- ▶ One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract.

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Series guidance

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

Customer options for additional goods or services

A customer's option to acquire additional goods or services (e.g., an option for free or discounted goods or services) is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

Principal vs. agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and, therefore, records revenue on a gross basis if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its

role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

- ▶ The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
- ▶ 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 (e.g., if the customer has a right of return).
- ▶ The entity has discretion in establishing the price for the specified good or service.

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

Variable consideration

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

Significant financing component

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

Noncash consideration

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment; a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

Consideration paid or payable to the customer

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity or equity instruments granted in conjunction with selling goods or services. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service.
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- ▶ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

Licenses of IP

The standard provides guidance on the recognition of revenue for licenses of IP that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either:

- ▶ A right to access the entity's IP throughout the license period (a right to access)
- ▶ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use)

To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories:

- ▶ **Functional:** This IP has significant standalone functionality (e.g., many types of software; completed media content, such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. However, we expect licenses of functional IP to meet the criteria to be recognized over time infrequently, if at all.
- ▶ **Symbolic:** This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP.

The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) 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). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).

Contract costs

ASC 340-40 specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. ASC 340-40 cites commissions as a type of incremental costs that may require capitalization. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory; property, plant and equipment; internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify.
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- ▶ The costs are expected to be recovered.

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment.