THE IMPACT OF THE REVENUE RECOGNITION PROJECT

by

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I examined the impact of the revenue recognition project, which was produced jointly by the Financial Accounting Standards Board and the International Accounting Standards Board as a way to improve the current accounting guidelines. I determined that, when implemented, the proposed standard would impact entities in three different ways. First, entities would incur implementation costs. Second, entities may restructure their business practices in response to the standard. Third, financial statement changes would occur for some entities. Specifically, I estimated that airline revenue would decrease by approximately 10% in the year the proposed standard is implemented because of the deferral of revenue from frequent flyer programs. These estimated impacts are due to the substantial differences between current United States Generally Accepted Accounting Principles and the proposed guidance in the revenue recognition project. The findings in this thesis suggest that some entities will need to prepare for the substantial changes associated with the implementation of the revenue recognition project.

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Introduction

The Financial Accounting Standards Board and International Accounting Standards Board are currently working together on a project that will redefine the way revenue is recognized for financial reporting purposes. This project works to find a middle ground between the accounting guidelines provided by each of these boards. It is also part of a larger trend of convergence between the guidelines produced by the two boards. The goal of this revenue recognition project is to create a set of new and improved guidelines that will be used in both United States Generally Accepted Accounting Principles and International Financial Reporting Standards.

This thesis aims to explore the implications of the revenue recognition project. This topic merits discussion because these new guidelines are likely to have a material impact on the financial statements of companies. By examining the background of accounting and revenue recognition along with an analysis of the current and proposed standards, this thesis should be able to determine some changes that the revenue recognition project is going to cause. More specifically, the objective of this thesis is to estimate the revenue recognition project's impact on U.S. airline's revenues generated from their frequent flyer programs during 2013.

Accounting Defined

The Oxford English Dictionary defines accountancy as "The art of formally recording, classifying, and interpreting financial transactions and associated events, and of calculating taxes due, esp. within the context of a business" ("Accountancy"). Accounting is used widely in the business world, mainly in order to prepare financial

statements and compute taxes. This thesis deals with financial statement preparation, rather than tax accounting. While the given definition summarizes the duties of an accountant, it fails to mention the accounting standards and guidelines that regulate accountants' actions regarding the treatment of specific economic transactions. The standards that govern accountants in the United States are the Generally Accepted Accounting Principles (U.S. GAAP), produced by the Financial Accounting Standards Board (FASB). The international counterparts are the International Financial Reporting Standards (IFRS), which are developed by the International Accounting Standards Board (IASB). The relationship between these two standards, in relation to the development of accounting standards, is the driving force behind this thesis. Both standards will be described with more detail in the following pages.

Another accounting term that will be used frequently in this thesis, and thus merits some special attention, is revenue. Revenue is defined as the "inflows or other enhancements of assets of an entity or settlements of its liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations" (FASB & IASB 2012). This means that revenue is the amount of compensation a company receives in payment for a good or service. Revenue is an extremely important component of a firm's accounting practices. Income statements start with revenue and then deduct other expenses and adjustments in order to yield the entity's net income for a given time period.

The recognition of revenue is at the center of this thesis, so it is important to establish exactly what revenue recognition is. Revenue recognition is an accounting principle that determines the requirements for an entity to realize income as revenue. It

is also the act of realizing income as revenue. Accountants receive guidance on revenue recognition from U.S. GAAP in the United States and IFRS internationally. The timing and amount of revenue to be recognized is the main focus of these guidelines. However, the current guidance is felt to be inadequate, which is why the revenue recognition standards are being redefined.

U.S. GAAP

The United States Generally Accepted Accounting Principles are the guidelines created by the FASB in order to regulate accounting practices in the U.S. These guidelines are contained in the Accounting Standards Codification (ASC), found on the FASB website, and described as "The single source of authoritative nongovernmental U.S. generally accepted accounting principles" (FASB). This means that all U.S. accounting practices are regulated by the FASB through the publication of the ASC. The goal of the FASB is "To establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports" (FASB). In order for the information to be useful, the financial reports of different companies must be comparable, accurate, and understandable.

U.S. GAAP codification is classified as a rules-based standard. Its guidelines are specific to certain scenarios and even prescribe different treatments for different industries. The industry specific guidance offered in U.S. GAAP leads to accounting for economically similar transactions in different manners, which is a major flaw of the guidance. These standards serve as a tool for accountants to use in order to treat

transactions in a uniform manner and ensure that there is a basis for comparison between different entities.

IFRS

A mention of IFRS is important in order to show the counterpart to U.S. GAAP and the other piece of the convergence puzzle. Much like the FASB develops U.S. GAAP, the International Accounting Standards Board develops the IFRS. The IASB is currently composed of 15 members who are responsible for the creation and interpretation of the IFRS. The goal of the IASB is to produce a set of standards that are "high quality, understandable, enforceable and globally accepted" (IASB). IFRS standards are widely used throughout the world, however they are not frequently used in the United States. U.S. companies are not permitted to use IFRS for the preparation of their financial statements, however they are able to use the standards to create unofficial statements for their own use. The U.S. is left out of the group of 110 countries currently using IFRS. Some notable users of IFRS are the countries of the European Union and Australia, with Canada and Japan also having plans to implement IFRS reporting.

IFRS is known for being principle-based, which means that the standards are rather broad and lack specific instructions. This requires a great deal of interpretation on the part of the accountant. IFRS is criticized for being too vague and leaving similar accounting scenarios open to multiple interpretations. The interpretative aspect of IFRS requires many disclosure notes in order to explain how the transaction in question was treated and why it was treated in that manner.

History of U.S. GAAP

Now that the basic functions of accounting have been reviewed, we are able to examine how the subject has come to be where it is today. One may be tempted to think that these standards are set in stone, however the truth is that they have changed along with society. The practice of recording transactions has been around for thousands of years, but the history relevant to this thesis begins in 1934 with the establishment of the Securities and Exchange Commission (SEC) in the United States (Waymire 2008). The SEC was the first organization in the U.S. to officially require some uniformity in accounting. Moving forward from 1934, the government, businesses, and the public shaped the U.S. accounting environment into its current form. The FASB began operations in 1973 in order to independently establish guidelines for the measurement and recognition of financial transactions (Zeff 2005). Since then the FASB has been responsible for producing the U.S. GAAP guidelines. The FASB was funded by private donations until 2002, when the Sarbanes-Oxley Act required that it operate from fees charged to public companies. This decision was made in order to reduce the influence that previous donors had over the development of accounting standards. Recently, the FASB has been working with the IASB on converging their respective sets of standards, with the revenue recognition project being an example of their efforts.

The concept of revenue recognition is currently one of the most complex areas of accounting, however it hasn't always been this way. From relatively simple beginnings, the guidance for recognizing revenue has grown larger and more complex along with the business environment. One reason revenue recognition has needed frequent improvement is its susceptibility to fraud. According to the Committee of

Sponsoring Organizations of the Treadway Commission (COSO), “Revenue frauds accounted for over 60 percent of the cases [in 1998-2007], versus 50 percent in1987-1997” (Beasley et al. 2010). This statistic shows the importance of stringent revenue recognition guidelines, while further demonstrating a need for the revenue recognition project. The bodies governing accounting practices historically, such as FASB, the Accounting Principles Board, the SEC, and many others, have issued many publications in an attempt to ensure accuracy in revenue recognition. These standard setters separately published more than 200 accounting standards, including guidelines, opinions, research bulletins, and interpretations. The ASC, which was published by the FASB in 2009, superseded all of the prior standards and condensed the revenue recognition guidance into ASC 605. This was done to make the guidelines more accessible and to increase reporting accuracy. The upcoming revenue recognition project will work to cut down on the number of requirements and simplify the guidance even further.

U.S. GAAP and IFRS on Revenue Recognition

The FASB and IASB have both developed their own respective standards describing how revenue can and should be recognized. For entities using U.S. GAAP, guidance on revenue recognition can be found in ASC 605, while IFRS reporters use IAS 18 and 11 for guidance. An examination of some of the major differences between U.S. GAAP and IFRS helps to show where the revenue recognition project is coming from and where some notable changes are likely to occur. As previously mentioned, U.S. GAAP is generally more specific, while IFRS is more open to interpretation. This distinction especially applies to the guidance concerning revenue recognition. A

sampling of some cases in which the two boards prescribe different treatments for similar transactions is included below.

Software Services

Software services merit special treatment under U.S. GAAP, while they are accounted for using the general revenue recognition principles under IFRS. The guidance for software services can be found in ASC 985-605 for U.S. GAAP. This topic prescribes accounting treatment for entities licensing, selling, leasing, or marketing computer software. A PwC publication states, "US GAAP guidance on software revenue recognition requires the use of vendor-specific objective evidence (VSOE) of fair value in determining an estimate of the selling price. IFRS does not have an equivalent requirement" (PwC 2013). The residual method of allocating revenue to separate performance obligations is permitted and widely used under IFRS, however U.S. GAAP only allows it in the accounting for software services. The guidance regarding revenue recognition from software services exemplifies the major difference between U.S. GAAP and IFRS standards. Software service accounting is given special, industry specific treatment in U.S. GAAP, while it is still accounted for using the broad principles of IFRS.

Construction Contracts

The treatment of construction contracts differs between U.S. GAAP and IFRS as well. Both standards state that the revenue should be recognized using the percentage-of-completion method when certain criteria are met. The U.S. guidelines specify exactly what the certain criteria are, and also require the completed-contract method to be used

when those criteria are not met. The FASB states, “the basic accounting policy decision is the choice between two generally accepted methods: the percentage-of-completion method including units of delivery and the completed-contract method” (ASC 605-35-25-1). The accounting is approached differently internationally, with the criteria for using the percentage-of-completion method not being specified, so the use of the method is based on the accountant’s judgment. The IFRS does not allow the use of the completed-contract method when percentage-of-completion can’t be used, but rather limits revenue recognition to the amount of recoverable costs incurred on the project. In the accounting for construction contracts major differences are evident between IFRS and U.S. GAAP. While both standards offer some specific guidance for the construction of assets, they prescribe completely different methods for recording the economic transactions.

Sale of Goods

The recognition of revenue from the sale of goods is fairly similar between the two standards, with the main difference being in the interpretation of language. U.S. GAAP requires that delivery has occurred, there is evidence of the sale, the fee is fixed or determinable, and collectability is reasonably assured, before revenue can be recognized. IFRS has four similar requirements for recognizing revenue from the sale of goods: the risk and reward of the good are transferred, the buyer has control, revenue can be measured reliably, and the economic benefit is likely to flow to the reporting company. The same basic idea of an exchange transaction dictating the recognition of revenue is evident in both standards, however they each have different requirements for determining whether this transaction has taken place.

Multiple Element Arrangements

The interpretive aspect of IFRS is apparent when comparing multiple element arrangement accounting in both standards. Both standards allow the company to recognize revenue when each element is delivered. FASB clearly defines what constitutes a separate element and what the requirements are for it to be considered delivered. IFRS also allows revenue to be recognized when an element is delivered, however there is no specific criteria stating what constitutes an element, so once again it is up to the interpretation of the accountant.

Customer Loyalty Programs

Customer loyalty programs reward an entity's customers for their purchases by providing a benefit to the customer. The practices of issuing customers frequent flyer miles when purchasing airline tickets or using credit cards with airline miles rewards are regulated by the guidelines concerning customer loyalty programs. Airlines in the United States use special transaction specific guidance in U.S. GAAP while international airlines are subject to standard IFRS revenue recognition guidelines. Both U.S. GAAP and IFRS allow these customer loyalty programs to be accounted for as multiple-element arrangements, however U.S. GAAP also permits the incremental cost method. These different accounting practices generally lead to more revenue being deferred under the multiple-element arrangement method of accounting and a greater amount of revenue being recognized up front with IFRS.

While a detailed comparison of U.S. GAAP and IFRS revenue recognition standards would far exceed the length of this thesis, this section provided several examples of the key differences in specificity, guidance, and language between the two

standards that are merging in the revenue recognition project. It is likely that the revenue recognition project will have the greatest impact where the accounting for similar transactions differs greatly between the two standards.

Convergence

There has been a recent trend of convergence between U.S. GAAP and IFRS, with the goal of developing a single set of standards to be used worldwide. The revenue recognition project is one of several large convergence projects. Since 1999 the FASB has shown a strong interest in convergence in order to improve U.S. GAAP standards and create more universal standards. They still feel that pursuing convergence is the correct decision for the U.S. and state, "The FASB's mission is to improve U.S. financial accounting standards … The FASB believes that pursuing convergence – making global accounting standards as similar as possible – is fully consistent with that mission" (FASB). Convergence is the next logical step for accounting standards because of the increase of international business. Comparability of financial statements from different countries would improve drastically if entities in both countries were using the same accounting standards. While the FASB still shows a strong interest in convergence, progress has recently slowed and the revenue recognition project is currently the last scheduled convergence project.

Calling for a Change

Although convergence is a major driving force behind the revenue recognition project, it is not the only one. The U.S. GAAP standards, as well as the international standards, are in need of improvement. Currently, the standards permit accounting that

does not accurately reflect the economic substance of some transactions. The specificity of the U.S. GAAP standards makes them difficult to interpret and generally confusing. The industry specific guidance results in different accounting practices for transactions that are economically similar just because they take place in different industries. U.S. GAAP is bound by such strict standards that complete compliance is difficult to achieve. The main problem with IFRS is its ambiguity. The standard's openness to interpretation makes it easy to be in compliance while still manipulating financial statements to produce favorable outcomes. The revenue recognition project is designed to be a solution to the problems present in both U.S. GAAP and IFRS.

The Revenue Recognition Project

The FASB and IASB began working on the revenue recognition project in 2008. Their aim is to create a set of guidelines that users of both U.S. GAAP and IFRS will implement for fiscal years beginning in 2017. The new standard will replace and improve the old ones, which are thought to have numerous faults. The general objectives of the boards are to remove inconsistencies and weaknesses present in current standards, to provide a more robust framework for dealing with revenue, to improve comparability, to provide more useful information through improved disclosure requirements, and to simplify the preparation of financial statements (FASB). Since the beginning of the project, two Exposure Drafts, which are drafts of the new guidelines that are open to public comment, have been issued. Although the final guidelines, which have been delayed several times, are not expected to be published until early 2014, it is possible to analyze the Exposure Drafts for the purpose of this thesis. The proposed standard contains the following 5-step process for recognizing revenue.

1. Identify the contract with a customer.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the separate performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

A closer, step-by-step, look at the specifics of the process laid out in the Exposure Draft can be found in Appendix 1.

These steps are quite different from the current U.S. GAAP guidelines. They are not industry specific, instead they are 5 steps that should be applied to all industries. With that said, it is reasonable to hypothesize that the application of these steps will yield financial statement results that differ from the ones derived from the current U.S. GAAP standards, especially for entities currently applying the industry specific guidance.

Public Comments

The public comments made in response to the two Exposure Drafts are meant to gather input from the people and organizations affected by the changes being made to the accounting standards. These comments can cover anything from complete disagreement with the project to suggestions for making the Exposure Draft better, yet they often include answers to questions posed by the accounting boards in the Exposure Drafts. For example, in the 2012 Exposure Draft the boards asked whether respondents agreed with the requirements for satisfying a performance obligation and whether respondents agreed with the proposed required disclosures. An analysis of the public comment letters for the revenue recognition project gives insight into how different entities feel about the project.

Some general trends in the comment letters show progress made on the revenue recognition project. For example, there were nearly 1,000 comment letters in response to the first Exposure Draft, while there were only 357 comments made on the second

Exposure Draft (FASB and IASB 2012). The decrease in the number of comment letters suggests that there is greater agreement with the second draft versus the first, which means the boards used the first round of comment letters to improve the proposed standard. The FASB feels that the number of comment letters was also reduced because "Many respondents appear to be comfortable with the overall model and its principles and, therefore, their comments are focused on a small number of specific issues or questions" (FASB and IASB 2012). Overall, the majority of respondents are in agreement with the objectives of the revenue recognition project and support its implementation. While there appears to be general support for the project, there are several issues that raised concern among respondents, so a closer examination of the specific issues addressed in comment letters follows.

Time Value of Money

The consideration of the time value of money in the calculation of revenues is a major change being implemented in the revenue recognition project. The proposed standard states, "In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract" (FASB & IASB 2012). Many comment letters show disapproval for this method of determining the contract price. For example, IBM states, "the proposed method of time value distorts economic reality when the timing of revenue recognition does not coincide with cash outflow by the seller" (CL #26). IMB believes that the time value of money aspect of the project fails to improve the quality of financial reporting, and thus should not be included. There is support for the inclusion of the time value of money for some transactions, however

determining which transactions should take the time value of money into consideration is difficult. A popular suggestion is the inclusion of the time value of money in revenues only when the contract has a significant financing component. However it is difficult to determine exactly what entails a significant financing component.

Construction Contracts

Companies operating in the construction industry appear to be the group most opposed to the revenue recognition project. Construction companies have enjoyed specific industry guidance with GAAP, however the project is removing that guidance and replacing it with the broader standards. The construction companies find the following matters as very significant: contract modifications, accounting for separate performance obligations, certain disclosure requirements, retrospective application, and consideration of the time value of money (CL #47). This extensive list of concerns shows that construction companies are concerned with the project and are likely to be impacted substantially upon the implementation of the new revenue recognition guidelines.

Onerous Testing

Knowing that onerous testing was a controversial issue, the boards posed a question to the public in the second Exposure Draft. The question asks whether respondents agree with the ruling that an "entity should recognize a liability and a corresponding expense if the performance obligation [satisfied over more than one year] is onerous" (CL #122). Essentially, the question asks whether entities should have to record a liability for performance obligations that are not likely to be profitable. The

boards state, “A performance obligation is onerous if the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation” (FASB & IASB 2012). The feedback from this question was mostly negative, with many comments stating complete disagreement with the inclusion of onerous testing. Many respondents have issues with guidelines affecting liabilities being included in the revenue recognition project. The respondent representing PwC states, “We disagree with including a requirement to assess whether a performance obligation is onerous, as it results in neither the recognition of incurred costs nor the recognition of revenue” (CL #33). This onerous testing would result in recording a loss for a particular performance obligation, regardless of whether the overall contract is profitable or not. The airline industry is extremely dissatisfied with the board’s issuance of the onerous testing. The onerous testing would result in airlines having to evaluate individual ticket sales and report losses on many of them, even though they are part of a flight that is profitable overall. This happens because airline tickets are priced variably depending on the type of the ticket and when it is purchased. In summary, respondents feel that onerous testing is impractical, counterintuitive, and should either be discarded or changed substantially before the implementation of the project.

Many of the major topics discussed in the public comment letters will likely have material impacts on entities’ financial statements. The entities’ concerns show that they have reason to believe they will be adversely affected when the revenue recognition project is implemented. While in many scenarios it is difficult to forecast exactly what that impact will be, the airline industry’s practice of providing customer loyalty programs offers an opportunity to estimate the impact that the revenue

recognition project will have on entities operating in that industry. In the following section the impact of the revenue recognition project is examined with special attention paid to the Airline industry's use of customer loyalty programs.

Impact of the Project

The implementation of the revenue recognition project is undoubtedly going to have a widespread impact on most organizations using U.S. GAAP and IFRS, as well as users of financial information prepared according to the standard. There are going to be substantial changes in the accounting processes used to recognize revenue, which will impact entities adopting the standard. The impact of the project will be felt in three ways: there will be costs associated with changing the accounting practices of companies, entities may reformat their business practices to be more compatible with the new revenue recognition standards in order to ensure more favorable accounting outcomes, and entities' financial statements will be materially changed. Below, this thesis attempts to determine the impact the project will have on general business practices and the effect of the project on revenue generated by the customer loyalty programs of airlines reporting in the United States.

Implementation Costs

In a comment letter, IBM states, "The Company has undertaken a preliminary estimate of the costs to apply this standard and currently projects a total cost of approximately $35-40 million" (CL #26). This estimate constitutes less than one percent of IBM's revenues, however the company would certainly rather spend these funds elsewhere. Like IBM, most entities will face varying degrees of implementation costs because of the revenue recognition project. These costs will consist of updating accounting software, training staff, and gathering the necessary information required for restating prior years financial statements, among other unavoidable costs. The comment

letter composed by the construction industry does not offer an estimate of implementation costs, instead it states, “The initial and on-going effort to implement these changes would be costly and burdensome, without producing meaningful information to the internal or external users of our financial statements” (CL #47). Entities in the construction industry appear to feel as if they will be wasting their money on implementing the proposed standard. In the aerospace industry, Boeing states that, “application of the proposed guidance could be costly, burdensome and impracticable due to the number, complexity and duration of our long-term contracts” (CL #125). It is evident that across several industries many firms are very concerned with the implementation costs of the proposed standard.

Restructuring of Business Practices

Entities have shown that they are willing to change the way they operate in response to changes in accounting standards. One notable instance of this occurred when the FASB issued Statement of Financial Accounting Standard 123R (SFAS 123R), which changed the way companies account for compensation in the form of stock options. SFAS 123R required that entities report stock option compensation as an expense on their income statement in the period issued and make adjustments to the fair value of the option at each following reporting date. This change resulted in higher expenses for companies using employee stock options, which in turn caused their net income to decrease. Instead of dealing with the consequences of SFAS 123R, companies decided to change their practices regarding employee stock options. Brown and Lee found that “firms cut back option-based compensation for their top five executives by 31 percent in response to the issuance of SFAS 123R” (Brown & Lee

2006). These results demonstrate the influence that accounting standard changes have on the practices of entities.

It is likely that the revenue recognition project will result in similar actions being taken by companies. The proposed guidance requiring the onerous testing of performance obligations could result in a change of business practices. Companies with long term contracts composed of several performance obligations will want to ensure that the performance obligations remain profitable in order to prevent reporting the liability associated with the onerous obligation. A scenario in which the proposed onerous testing could trigger a business practice change is the sale of concert tickets. Tickets are priced differently depending on when they are sold, where the associated seats are located, and any additional benefits the ticket provides. The overall profitability of the concert may be dependent on the sale of certain tickets because others are sold at a loss. A company putting on a concert could be faced with reporting liabilities due to onerous testing. Possible responses to this scenario will likely affect the pricing of the contract and its performance obligations. One possibility is that an entity could increase the selling price of the tickets to avoid reporting the onerous testing related liability. The company could also strategically group the tickets in order to match profitable tickets with tickets sold at a loss, thus avoiding an onerous situation. This would be a way of preventing a loss from being projected during the life of the contract. The pricing of concerts is very similar to that of flights provided by airlines, so it is likely that similar restructuring actions will be taken in both industries. Of course, any changes made by entities must comply with the relevant U.S. GAAP guidelines, which includes estimates being reasonable. While it is difficult to say exactly what steps

businesses will take to reduce negative results as a result of the revenue recognition project, entities will assuredly adapt their practices to the new standard.

Financial Statement Impact: Customer Loyalty Programs

Airlines have been offering customer loyalty programs for over 30 years as a way to encourage repeat customers and increase air traffic. Today, nearly all U.S. airlines offer frequent flyer programs as a type of customer loyalty program. For this study, nine major U.S. airlines are examined, all of which have frequent flyer programs. Airlines implement two different kinds of customer loyalty programs: fly-for miles and third party sales. This analysis focuses on fly-for miles, which provide value to passengers by rewarding them with a benefit for every mile they fly, and then allowing the passenger to later redeem the accrued benefit for free flights. The benefit comes in the form of miles or points, of which a certain amount is required in order to earn the free airfare. In order to gain these rewards, passengers usually have to enroll in some sort of frequent flyer club, which may require fees for membership. For example, a frequent flyer club member on a hypothetical flight from Eugene, Oregon to New York City would earn approximately 2,500 frequent flyer miles. Assuming this program requires 12,500 miles in order to earn a free flight, the passenger would have to take the same flight four more times before being able to fly for free.

Currently, airlines account for the purchase of tickets using the incremental cost approach, which results in the recognition of revenue when the passenger takes the flight they booked. For passengers earning frequent flyer miles, the airlines record an expense and accrue a liability for the estimated cost of providing the future travel. This practice is not going to comply with the guidance proposed in the Exposure Draft. The

airlines will have to apply the five-step process for revenue recognition in order to determine how much revenue to recognize and when to recognize it.

In Step 1 the airline would identify the sale of a ticket as the contract, which gives the customer a seat on a flight in exchange for a payment. To simplify the contract, we will say the only performance obligations identified in Step 2 are the booked flight and the frequent flyer miles to be earned. The frequent flyer miles now qualify as a separate performance obligation because they are regularly sold by the airline and the customer benefits from them. In Step 3 the transaction price would be the price the customer paid for the ticket. Next, in Step 4 the transaction price would be allocated between the booked flight and the frequent flyer performance obligations based on their standalone selling price. Evidence of the standalone selling price for the frequent flyer miles is readily available on the airline websites, on which they offer customers the opportunity to buy miles instead of earning them. For the 5th and final step the airline would recognize revenue for the booked flight when the passenger takes the flight and they would recognize the revenue for the frequent flyer miles when the customer flies using those reward miles. This deferred revenue approach results in deferred revenue being recorded, when before it had not.

Several assumptions and estimations were made in order to determine the amount of revenue that would have been deferred during 2013, had the airlines been subject to the proposed guidance in the revenue recognition project. First, it was assumed that frequent flyer mileage was awarded at a constant rate of one per mile flown. While this does not conform with the airline practice of offering double or triple award miles to certain passengers, it makes the computation of deferred revenue

possible. The inability to track frequent flyer rewards to individual passengers limits this study to this assumption, which potentially understates the effect of the proposed standard, suggesting the effect may be larger. Second, not all airline passengers earn frequent flyer miles, but unfortunately credible estimations of the percentage of passengers who earn reward miles are unavailable, so estimations of 60% (Table 1) and 80% (Table 2) were made. Third, some of the frequent flyer miles awarded during the reporting period are redeemed during the same period, which means that not all of the revenue allocated to the frequent flyer miles will be deferred into the next reporting period. The percentage of reward miles both earned and redeemed in the same period was estimated to be 40%. This estimate was made using data from 1981 to 2005, which included the number of miles awarded and redeemed for each year (Petersen 2005). The percentage of award miles redeemed during the same year was calculated for each year, and then averaged over the 25-year span in order to yield the 40% estimate used. Finally, this study assumes that the selling price per mile is the price at which revenue will be deferred. Using the information currently provided by airlines, this is the best valuation available, however airlines may have an undisclosed estimate of price for their frequent flyer miles that more accurately values them. These four assumptions were necessary in order to generate reasonable estimates for the amount of revenue that would have been deferred in 2013. Although they may not be correct, these assumptions are reasonable and likely did not cause any of the resulting figures to be materially incorrect.

The figures in the following tables were taken from airline websites, and from the companies' 2013 Form 10k filings with the SEC. The frequent flyer mileage pricing

information was taken from each airlines website, while the revenue and passenger mile figures were taken from the 10k filings. In order to establish the value of a frequent flyer mile, the selling price of multiple miles was divided by the number of miles sold. The resulting figure, the price per mile, was then used to calculate the deferred revenue by multiplying it by revenue passenger miles, the estimate of the percent of passengers earning reward miles, and the estimate of award miles not redeemed during the period. This process yielded individual estimates of the 2013 ending balance of deferred revenue for each airline. A very similar process was followed for the airlines using point rewards instead of mileage rewards. What follows are Table 1 and Table 2, which use the previously described methods and estimates of passengers earning frequent flyer awards (60% and 80%, respectively) in order to estimate the amount of deferred revenue for each airline.

In order to further illustrate this process, the calculations leading to the estimation of Alaska Airline's deferred revenue are detailed in this paragraph. The airline's website, alaskaair.com, offers 1,000 frequent flyer miles at a price of $27.50, which yields a per mile price of $0.0275. The relevant revenue passenger miles were then calculated by taking Alaska's 28,883 million 2013 miles and multiplying them by the 80% estimate of passengers receiving rewards, to get 23,106,400,000 miles. These two resulting figures were then multiplied together to determine the amount of 2013 deferred revenue that would have been accumulated, had no miles been redeemed during the year. The resulting product between the $0.0275 per mile price and the 23 billion miles results in a deferred revenue of $635,426,000. This figure was then adjusted for the estimate of 40% of award miles being both earned and redeemed in the

same period. This was done by multiplying the $635 million by .6, the amount of miles not redeemed during the year (100%-40%), which resulted in an estimated 2013 deferred revenue of $381, 255,600. A similar process was performed for each airline in both Table 1 and Table 2.

Table 1: 60% of Passengers Earning Rewards

Airline	Purchase Price	Purchase Miles	Price Per Mile	2013 Revenue Passenger Miles	2013 Passenger Mile Revenue	Revenue Per RPM	Estimated Deferred Revenue Under New Guidance	Estimated Revenue Reduction Under New Guidance
Alaska	$ 27.50	1000	$0.0275	28,883,000,000	$ 4,267,000,000	$ 0.147734	$ 285,941,700	6.70%
American	$ 29.50	1000	0.0295	128,413,000,000	23,349,000,000	0.181827	1,363,746,060	5.84%
Delta	$ 70.00	2000	0.0350	194,988,000,000	32,942,000,000	0.168944	2,456,848,800	7.46%
Hawaiian	$ 14.78	500	0.0296	13,658,072,000	1,942,177,838	0.142200	145,343,739	7.48%
JetBlue*	$ 37.63	1000	0.0376	35,836,000,000	4,971,000,000	0.138715	404,046,857	8.13%
Southwest*	$ 50.00	2000	0.0250	104,348,216,000	16,716,584,203	0.160200	1,354,043,320	8.10%
Spirit	$ 26.88	1000	0.0269	12,001,088,000	986,018,000	0.082161	116,132,128	11.78%
United	$ 75.25	2000	0.0376	205,167,000,000	33,122,000,000	0.161439	2,778,987,015	8.39%
US	$ 35.00	1000	0.0350	65,613,000,000	13,021,000,000	0.198452	826,723,800	6.35%
		TOTAL		788,907,376,000	$ 131,316,780,041		$ 9,731,813,420	
*uses point system		**AVERAGE**	$0.0315	87,656,375,111	$ 14,590,753,338	$ 0.153519	$ 1,081,312,602	7.41%

Table 2: 80% of Passengers Earning Rewards

Airline	Purchase Price	Purchase Miles	Price Per Mile	2013 Revenue Passenger Miles	2013 Passenger Mile Revenue	Revenue Per RPM	Estimated Deferred Revenue Under New Guidance	Estimated Revenue Reduction Under New Guidance
Alaska	$ 27.50	1000	$0.0275	28,883,000,000	$ 4,267,000,000	$ 0.147734	$ 381,255,600	8.93%
American	$ 29.50	1000	0.0295	128,413,000,000	23,349,000,000	0.181827	1,818,328,080	7.79%
Delta	$ 70.00	2000	0.0350	194,988,000,000	32,942,000,000	0.168944	3,275,798,400	9.94%
Hawaiian	$ 14.78	500	0.0296	13,658,072,000	1,942,177,838	0.142200	193,791,652	9.98%
JetBlue*	$ 37.63	1000	0.0376	35,836,000,000	4,971,000,000	0.138715	538,729,142	10.84%
Southwest*	$ 50.00	2000	0.0250	104,348,216,000	16,716,584,203	0.160200	1,805,391,094	10.80%
Spirit	$ 26.88	1000	0.0269	12,001,088,000	986,018,000	0.082161	154,842,838	15.70%
United	$ 75.25	2000	0.0376	205,167,000,000	33,122,000,000	0.161439	3,705,316,020	11.19%
US	$ 35.00	1000	0.0350	65,613,000,000	13,021,000,000	0.198452	1,102,298,400	8.47%
		TOTAL		788,907,376,000	$ 131,316,780,041		$12,975,751,226	
*uses point system		**AVERAGE**	$0.0315	87,656,375,111	$ 14,590,753,338	$ 0.153519	$ 1,441,750,136	9.88%

A comparison of the 60% and 80% estimations shows that the 20% difference between them results in an increase of $360 million in average deferred revenue. This means that a 1% change in the amount of passengers earning rewards causes an $18 million shift in average deferred revenue. This $18 million to 1% factor allows further estimates to be made simply by adding or subtracting deferred revenue based on changes of the estimate of passengers earning rewards. The following discussion will focus mainly on Table 2 because a discussion of both tables would present similar conclusions with little more than different values. The revenue recognition project appears as if it will have a fairly substantial impact on the airline industry, with over $1.4 billion for each company being deferred on average, and cumulative deferred revenue of nearly $13 billion for the whole industry. This deferral amounts to just under 10% of the industry's $131 billion 2013 revenue being recognized in future periods. With the airline industry not being highly profitable across the board, it is likely that some airlines will be adversely affected when the revenue recognition project is adopted in 2017. Spirit Airlines exhibits the largest percentage of estimated deferred revenue, which would have had a substantial impact on their financial statements. Looking at the company's income statement, they reported a 2013 operating income of $282,292,000, which would have been reduced from by $154,842,838 to $127,449,162. This reduction in operating income would also cause a reduction in net income, although it may be lessened by the deferral of various expenses. Airlines will be deferring a large portion of their revenue, which will cause their net income to decrease in the year the revenue recognition project is applied.

It is important to remember that this deferred revenue is by no means lost. The airline will recognize it eventually, either when the passengers redeem their rewards in future periods, or as breakage, when they believe that the passenger is never going to redeem the miles. For this reason, the biggest impact of the revenue recognition project will come in the year of its inception, with the impact diminishing over time. In the first period the airline passengers will only be redeeming miles they earned that period, but in the second period they will be redeeming miles from both the first and second periods. This trend continues as miles accumulated and deferred in prior periods are redeemed and recognized as revenue in the current period. This allows the airlines to recognize more revenue each period, as a greater number of miles are redeemed each period. The fact that the airlines' revenue will normalize over time implies that the impact of the changes is a timing issue, rather than a question of valuation. In summary, airlines are likely to experience a substantial one-time decrease in revenue in the first reporting period following the adoption of the revenue recognition project standards.

Benefits of the Revenue Recognition Project

The revenue recognition project will have some positive impacts in addition to the negative impacts received by businesses. FASB will likely be successful in accomplishing most, if not all of its goals for the project. The most important of which is likely the improvement of comparability between entities. While it is difficult to quantify the rest of the FASB's goals, recent research by DeFranco et. al. suggests that comparability between organizations provides a measurable benefit for firms. The authors determined that "comparability leads to greater analyst following, … is positively associated with forecast accuracy, … lowers the cost of acquiring

information, and increases the overall quantity and quality of information available" (Defranco et. al. 2011). These results are based on the idea that the use of comparable accounting systems leads to the creation of similar financial statements. So, following this idea, it is completely reasonable to suspect that the simplification of accounting guidelines occurring in the revenue recognition project, and their consistent application across all industries, will lead to greater comparability between entities. Ongoing research by Peterson et. al., which uses a different measure of comparability, suggests that comparability improves earnings quality, improves analyst forecasting, increases the co-movement of stocks, and decreases the bid-ask spread (Peterson et. al. 2014). By using the methods prescribed by these authors one could measure the revenue recognition project's impact on comparability between the financial statements of firms and its corresponding benefit to the firms and their stakeholders. The results would likely indicate that the project caused a substantial increase in comparability.

Another potential benefit of the revenue recognition project is the reduction of revenue-related fraud. As previously mentioned, fraud has always been prevalent in the accounting for revenue. The revenue recognition project looks to make the guidelines more robust and less susceptible to fraud. The use of a common revenue recognition standard across all industries will make fraud more detectable by making any outlying figures more noticeable when compared to other entities reporting using the same standards. Any entity reporting revenue figures that substantially differ from its competitors will be detected more easily. The simplification of the guidelines could also decrease fraud by eliminating the complexities associated with the current, very specific guidelines. Upon implementation of the project, entities committing fraud will no

longer be able to claim a misinterpretation of the complex guidelines as an excuse for an intentional material misstatement of financial statements. It is also important to recognize that a counterargument exists in that the proposed less specific guidance will allow greater interpretation by accountants and an increase in the frequency and magnitude of fraud. Optimistically, the proposed revenue recognition standard will decrease the amount of fraud related to revenue recognition.

Conclusion

Revenue is a crucial figure to the preparation of financial statements, the evaluation of an entity, and its overall profitability. It has been subject to numerous changes in the past in attempts to ensure the accuracy and comparability of reporting. The latest attempted improvement of the accounting standards concerning revenue recognition comes in the form of the revenue recognition project, which is the product of cooperation between the FASB and the IASB. Upon the project's implementation in 2017, most companies are going to be affected. This thesis determined that most entities will face implementation costs, some entities will restructure their business practices, and some entities' financial statements will be substantially impacted. Specifically, it was determined that airlines are going to be adversely affected because of a substantial deferral of frequent flyer program revenue. Members of the airline industry, as well as other industries, certainly need to develop strategic plans for the changes associated with the revenue recognition project. Whether they involve a change to their business practices or the development of disclosure statements explaining the effect of the project, it is important that the all companies and their stakeholders fully understand the impact of the revenue recognition project.

Appendix 1: Description of the New 5-Step Process

Step 1: Identify the Contract with a Customer

This step is rather simple and only involves the entity identifying the enforceable contract with a customer. This contract can be written, oral, or even implied by the business' customary practices. The remaining four steps would then be applied to the contract identified in this step.

Step 2: Identify the Separate Performance Obligations in the Contract

In this step the entity is determining which performance obligations in the contract are distinct and need to be accounted for separately, rather than being combined with the other obligations in the contract. For a performance obligation to be distinct, it needs to meet either of the following criteria.

1. The entity regularly sells the good or service separately.
2. 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

If the previous criteria are not met, the contract may be able to be accounted for as a single performance obligation, but only if both of the following criteria are met.

1. The goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted.
2. The bundle of goods or services is significantly modified or customized to fulfill the contract.

The entity would complete this step knowing whether its contract consists of distinct performance obligations, bundled performance obligations, or a combination of both.

Step 3: Determine the Transaction Price

In this step the entity determines the amount of consideration they expect to receive for the completion of the contract. The entity must take into account variable consideration (e.g. fees that vary based on some future event), the time value of money, noncash consideration, and consideration payable to the customer when computing the transaction price.

Step 4: Allocate the Transaction Price to the Separate Performance Obligations in the Contract

This step details the procedure for dividing the total transaction price, determined in Step 3, between the separate performance obligations in the contract, which were identified in Step 2. This involves determining or estimating the standalone selling price of each separate performance obligation and then allocating the transaction price based on the performance obligations' relative standalone selling price. In other words, if a separate performance obligation makes up 20% of the total standalone selling price of all the performance obligations in a contract, then that same separate performance obligation will be allocated 20% of the transaction price.

Step 5: Recognize Revenue when the Entity Satisfies a Performance Obligation

In this, the final, step the entity is able to recognize revenue on the contract identified in Step 1. Revenue is recognized when the transfer of the good or service is complete and the customer takes control of it. The revenue from a performance obligation can be recognized either at a point in time or over time. The entity must determine whether the performance obligation is satisfied over time, which is done by checking if it meets at least one of the following criteria.

1. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
2. The entity's performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:

   (a) The customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs.

   (b) Another entity would not need to substantially reperform the work the entity has completed to date if that other entity were to fulfill the remaining obligation to the customer.

   (c) The entity has a right to payment for performance completed to date and it expects to fulfill the contract as promised.

If the entity determines that a performance obligation is satisfied over time, they would then recognize the revenue as the obligation is satisfied by using input or output methods to measure the progress made toward satisfying the performance obligation. When performance obligations fail to meet the aforementioned criteria, their revenue must be recognized at the point in time at which the transfer of control of the asset occurs. The proposed standard lists several indicators of the transfer of control of an

asset, some of which are the right to payment, retention of title, possession, right to risk and reward, and acceptance of the ownership of the asset. After completing this step the entity has completed the entire process by satisfying the performance obligations detailed in their contract with the customer and recognizing revenue based on the allocation of the transaction price.

Appendix 2: Airline Industry Comment Letter

American Airlines
Comment Letter No. 973

Brian J. McMenamy
Vice President and Controller

March 24, 2011

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
Attn: Technical Director
(via email) director@fasb.org

Re: File Reference No. 1820-100, Exposure Draft: *Revenue from Contracts with Customers*

Dear FASB Technical Director:

As Controllers for the 5 largest U.S. passenger airlines we felt compelled to express our concerns about certain recent deliberations on the Exposure Draft, *Revenue from Contracts with Customers* (the "ED"). Although we support the Boards' efforts to clarify and provide comprehensive guidance covering revenue recognition, we are concerned with the tentative conclusions reached on March 1, 2011 regarding the onerous contracts, as follows:

> Onerous Contracts
>
> The IASB and FASB continued their discussion from February 2011 on how an entity would test a contract to determine whether it is onerous.
>
> The Boards tentatively decided that the onerous test should apply to all contracts, including those that are intentionally priced at a loss in expectation of profits to be generated on subsequent contracts with the customer (that is, "loss-leader" contracts).
>
> The Boards tentatively affirmed the proposal in the Exposure Draft, *Revenue from Contracts with Customers*, that the costs to be included in the onerous test and in measuring an onerous liability should be the costs that relate directly to satisfying the remaining performance obligations (as described in paragraph 58 of the

Exposure Draft). The Boards observed that when an entity is committed to cancelling a contract and has the contractual right to do so, the costs would reflect the amount that the entity would have to pay to cancel the contract (for example, the amount it would have to refund the customer, including any penalties). The Boards also observed that cancelling the contract may give rise to other obligations that would be accounted for in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets, or Topic 450, Contingencies, of the FASB Accounting Standards Codification®.

We have been monitoring the Boards' progress and commentary during redeliberations and we have concerns that the boards' tentative conclusions with regard to onerous contracts potentially create significant volatility in our industry results. Further, we do not believe the accounting resulting form the tentative conclusions results in better presentation of the true economic performance of the industry.

Our concerns are specific to the onerous performance obligation provisions of the ED (paragraphs 54.-56.) and the application of such provisions to accounting and reporting in the airline industry. We noted that the ED indicates that an entity would apply the requirements of the proposed revenue recognition model to a single contract with a customer. Each ticket purchase by one of our customers (which range from being purchased several months in advance to being purchased on the flight date) is an individual contract. The basis of our specific concerns relates to applying the "cost trigger" method (as defined in paragraph BC138(a)) to individual tickets in a manner that is substantially inconsistent with the revenue management systems we used to price and determine profitability of our products. Part of our strategy to sell tickets involves multiple sales prices depending on the length of time someone is willing to commit to purchase and refundability of the ticket. In essence this strategy has been developed over the years as the best way to optimize the total yield for our commodity product (effectively an airline seat is a perishable commodity spoiling at the time of the flight if unused). As we understand your proposal, we would be required to identify and record a loss at the individual ticket level. This would include being required to recognize a loss on certain advance tickets at the time of sale; even though we expect that the contract would be fulfilled on a profitable flight. As a result, under this model, profitability reported in periodic financial reports would be more of a function of the volume and mix of tickets sold rather than passengers flown.

This is substantially inconsistent with how we operate and evaluate the profitability and success of our business and how our investors evaluate our results. To better explain our concerns, we have included below some key aspects of our business to demonstrate why it is not practical to test profitability at the ticket level and why we believe it will not improve airline financial reporting.

Measurement level- The proposed revenue recognition guidance is founded on the principle of fulfilling an obligation. An airline's obligation is generally fulfilled on a flight or group level with other passenger tickets and, absent a refund, never on an individual contract or ticket level. In the airline business we can only reasonably

assess profitability at a flight level and even then with some limitations as described below. The real difficulty in going below the flight level is the inability to allocate costs to individual seats in a way that reasonably resembles how we operate our business. In simple terms we do not believe that all seats are equal, such that an airline's per seat cost is simply a ratable allocation of total cost. The airline pricing model places different value and price on the first advance purchase seats sold on a plane versus a last minute seat on the same flight, similar to other commodity pricing models. As a result, a model that only permits a ratable cost allocation to the seats disregards the most significant economic reality of our business – supply and demand.

Cost structure- The airline industry has a significant portion of its costs that are fixed in nature, such as capital costs (to buy or lease aircraft) which after fuel and labor represent one of our most significant costs. However, their fixed nature do not necessarily lend themselves well to simple allocations. To illustrate an airline that flies an aircraft for 8 hours a day and is considering adding an additional daily frequency to increase the aircraft utilization to 10 hours a day. In this example the basic capital cost of the aircraft does not change, and in fact declines on a per unit basis. As a result an airline may make a decision to fly one extra trip between two cities in the evening knowing the demand may not be as great for that flight as the other flights during the day. In reaching this conclusion, airline frequently use a variable cost recovery model to evaluate this additional frequency, such that as long as the flight covers its variable costs (fuel, food, maintenance, etc.) then it contributes to the recovery of the fixed costs. In this example, using a ratable allocation of the per sat capital costs does not represent the economics of how our business is operated or how we make scheduling decisions.

Network benefit- Although, not all airlines us a network model, it is common and used by 4 of the 5 airlines signatories on this letter. A network model or hub and spoke model flies a number of flights to an airport hub to connect passengers with other departing flights to create the maximum possible flight options. Airline that use this model will frequently fly certain routes that would not be fully profitable on a standalone basis, but provide valuable feed for other, more profitable flights, operated by the Airline. In addition, certain flights, for example the last flight of the day, may frequently be operated below an optimal profitability, in order to properly position the aircraft for the following morining's flight that is very profitable.

Ancillary Revenue- A final complicating factor is the growth of ancillary revenues sources associated with passenger transportation, such as baggage fees and change fees. These revenues now represent over 10% of total industry revenues and are a disproportionally larger percentage of advance purchased tickets, which is the population most at risk to result in a potential ticket level onerous contract provision. These fees are frequently not aid until after the initial purchase, but yet are anticipated as part of the original contract or ticket (e.g. based on ticket type, if the passenger changes their flight or checks a bag we would earn additional revenues). While not all customers use these services and pay these fees, historically we can

easily estimate that a high percentage of these customers ultimately incur these fees. As a result, we believe any ticket level assessment would need to include an estimate of additional fees as a part of the computation, adding an additional layer of complexity to this effort.

The explanations above hopefully give you a better understanding as to our view that this accounting does not match the economic reality of our business and would in fact result in less meaningful financial reporting. To further support our views, we polled a few of the primary airline analysts and described to them the onerous contract accounting and the currently proposed allocation methodologies to the airline business. In each case they indicated they did not believe that this would help their evaluation, and in fact, would dramatically change many of the measures that they traditionally used to evaluate the industry, complicating their evaluation of the airline industry.

We would appreciate the opportunity to discuss our thoughts in-person, and to discuss how possible alternate models might better achieve the desired objective, specifically we believe that the Boards should either permit aggregation of performance obligation in situations where the company can demonstrate consistency with their model for fulfilling such obligations or alternatively, provide that cost allocation methodologies may be prepared consistently with how the company operates and evaluates their business. We are sensitive to your time constraints in reaching a final Accounting Standards Update regarding this matter, and we appreciate the opportunity to take part in the process for creating a comprehensive and simplified revenue recognition standard.

Very truly yours,

Brian McMenamy
Vice President and Controller
American Airlines, Inc.

Chris Kenny
Vice President and Controller
United Continental Holdings, Inc.

Craig Meyhard
Managing Director of Accounting
and Reporting
Delta Air Lines, Inc.

Michael Carreon
Vice President and Controller
US Airways Group. Inc.

Appendix 3: Glossary of Terms

Breakage: The recognition of revenue for obligations that are never expected to be fulfilled.

Convergence: Making global accounting standards as similar as possible.

Deferred Revenue: A liability account reporting revenues for which consideration has been received, but the service has not yet been provided.

Disclosure: The act of releasing information relevant to a transaction.

Form 10k: A required report summarizing a company's yearly performance, due to the SEC annually.

Onerous Testing: The determination of whether the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation. If yes, it is onerous.

Performance Obligation: A promise in a contract with a customer to transfer a good or service to the customer.

Revenue: The net amounts payable to the entity from a third party.

Revenue Recognition: The act of recording income as revenue on a company's books.

Transaction Price: The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

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