

Implications of ASC 606 on Airline Financial Statements

By Shivam Arora

EXECUTIVE SUMMARY

For airlines with loyalty programs, implementing Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers*, had several implications. These included the reclassification of ancillary fees and change fees on the income statement as well as the exponential increase in loyalty program liabilities on the balance sheets of airlines historically employing the incremental cost method of accounting.

Airline loyalty programs have remained a controversial subject with both customers and federal agencies since their inception about four decades ago. Loyalty programs have been accused of being too complex, mysterious, and of involving an element of deceit.¹ The concept of awarding “miles” or “points” to customers with each qualifying purchase has received mixed responses over its effectiveness to develop a loyal customer base. (In the remainder of this article, “points” will be used to refer to loyalty program credits.) Frequent-flyer programs have sometimes been criticized for favoring airlines and being deceptive to customers, as evidenced by the U.S. Department of Transportation’s 2016 audit of its oversight of frequent-flyer programs.²

Accounting practices for frequent-flyer programs require consideration of the channel through which points are awarded to customers and of associated revenues and costs. Two approaches have emerged over time under U.S. Generally Accepted Accounting Principles (GAAP) to account for points awarded with purchases of air tickets or other products: the incremental cost approach and the deferred revenue approach.

Under the incremental cost approach, airlines recognize all revenue related to a qualifying purchase by a customer after satisfying their performance obligation and record the esti-

mated cost of providing future travel through award redemption as a liability. Under the deferred revenue approach, airlines assign part of the revenue realized during the point-of-sale transaction to awarded points. This revenue is deferred and recognized with the redemption, forfeiture, or expiration of points.

The incremental cost method assumes that the value of points awarded in a sales transaction is insignificant compared to the value of the overall transaction, so they may not be considered as a separate performance obligation. Accordingly, only the incremental cost of honoring award commitments in the future should be accrued as an expense at the time of sale. Since the incremental cost of carrying one passenger is remarkably lower compared to the revenue that could be attributed to points, most airlines have traditionally preferred the incremental cost method over the deferred revenue method.

Yet the treatment of loyalty points may change with Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers*, issued jointly by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on May 28, 2014. It provides guidance for recognizing revenue arising from contracts with customers and standardizes revenue recognition rules across U.S. GAAP and International Financial Reporting Standards (IFRS). The core principle of the standard, per the FASB, is that “an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”³ ASC 606 specifically applies to contracts with customers, where a customer “is a party who has contracted to obtain a good or service that is output from the company’s ordinary activities.”⁴ As such, the standard affects most aspects of transactions that airlines have with their customers, including those related to the award of frequent-flyer points as part of loyalty programs. The new standard effectively mandates the deferred revenue method of loyalty accounting.

This study assesses the financial reporting implications that implementing the updated ASC 606 will have on airline loyalty programs. It describes the changes required in current accounting practices of airline loyalty

programs and the impact of adopting the standard by analyzing public filings of major U.S. airlines with the U.S. Securities & Exchange Commission (SEC) for the first two interim reporting periods of 2018.

REVENUE RECOGNITION STANDARDS

Revenue recognition has historically been one of the most important aspects of a company’s accounting system. Generating revenue by fulfilling customer needs is the primary source of income for most entities and is a fundamental requirement for maintaining continuity of operations under the “going concern” concept in accounting. Revenue is also an integral part of stakeholders’ analysis about the financial health of a company. Consequently, revenue recognition standards set by relevant authorities need to be carefully thought over and created to ensure uniformity in revenue recognition practices.

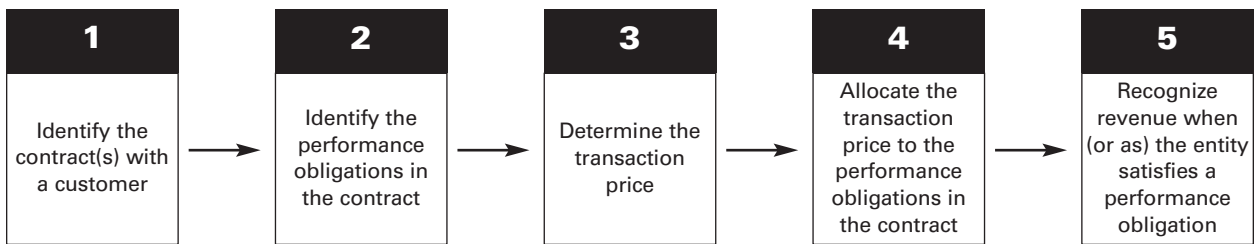
Prior to the issuance of ASC 606, accounting for revenue recognition under U.S. GAAP sharply contrasted with that under IFRS. This caused inconsistent accounting for companies reporting under both IFRS and GAAP for various reasons and discouraged comparison of revenue recognition practices (and financial statements at large) between U.S. and non-U.S. entities.⁵

In view of these issues, the FASB and the IASB jointly issued a “converged” standard to streamline revenue recognition accounting between the two boards and facilitate comparison of financial statements. According to the FASB, “previous revenue recognition guidance in U.S. GAAP comprised broad revenue recognition concepts together with numerous revenue requirements for particular industries or transactions, which sometimes resulted in different accounting for economically similar transactions. In contrast, IFRS provided limited guidance and, consequently, the two main revenue recognition standards, IAS 18, *Revenue*, and IAS 11, *Construction Contracts*, could be difficult to apply to complex transactions.”⁶

ASC 606 and IFRS 15, both known as *Revenue from Contracts with Customers*, addressed major inconsistencies of revenue recognition practice between the two sets of accounting standards. According to the FASB, the converged standard serves to:

1. Remove inconsistencies and weaknesses in

Figure 1: The Five-Step Process



revenue requirements.

2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.⁷

Entities are required to carefully analyze their transactions with customers to identify contract obligations. Specifically, the standard is intended to achieve the core principle that “an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”⁸ The standard can be applied by following the five-step process to achieve the core principle, per the FASB (see Figure 1).

ACCOUNTING FOR LOYALTY PROGRAMS

As noted previously, two approaches have emerged under U.S. GAAP to account for loyalty program initiatives by airlines. The two approaches are strikingly different, and the application of one or the other causes a material impact on an airline’s frequent-flyer liability on the financial statements.

Incremental Cost Method

Prior to ASC 606, most airlines used some form of cost method to account for points. Although full costs may be considered, most airlines today consider incremental costs. Under the incremental cost model, airlines do not consider loyalty points as a separate performance obligation and recognize all revenue related to the transaction as the performance obligation is satisfied (as the customer takes the flight and earns the points).⁹ Simultaneously, airlines record a liability in an amount equal to the estimated additional cost of fulfilling its loyalty program obligations in the future. This liability may include cost items such as food, complimentary lodging, baggage handling, etc. Generally, airlines adjust the amount of liability by an estimated “breakage” of points expected. Breakage refers to points that an airline predicts (usually based on historical data) will expire unredeemed and hence should not be accounted for. The viability of the incremental cost method depends on a reasonable assurance that customers redeeming loyalty points will be occupying reserved seats such that the costs of carrying such customers is incremental and does not include any opportunity costs or an effect on fixed costs.¹⁰

Deferred Revenue Method

Under the deferred revenue method, airlines account for loyalty points by deferring part of the revenue received from the sale transaction. The deferred part is attributed to points using methods such as the fair value approach. No separate liability is recorded. This ap-

Table 1: Loyalty Program Accounting Journal Entries

	Incremental Cost Method			Deferred Revenue Method		
		Debit	Credit		Debit	Credit
At the Time of Sale	Cash Deferred Revenue	xx	xx	Cash Deferred Revenue	xx	xx
Performance Obligation Satisfied	Deferred Revenue Revenue	xx	xx	Deferred Revenue Revenue	dd	dd
	Operating Expense Cash/Payable	yy	yy	Operating Expense Cash/Payable	yy	yy
	Loyalty Program Expense (Estimated) Incremental Cost Liability	ee	ee	— —	—	—
Points Redeemed/ Expired in Future	Incremental Cost Liability (Actual) Cash/Payable	aa	aa	Deferred Revenue Revenue	xx - zz	xx - zz
	— —	—	—	Loyalty Program Expense Cash/Payable	aa	aa

proach considers loyalty points to be a separate part of the sales transaction. Airlines recognize this revenue when they fulfill their (separate) performance obligations of providing services in exchange for points, or if the points expire without redemption.

Since most costs of an airline are fixed, the incremental cost of carrying loyalty program customers is lower compared to the revenue attributed to points. The deferred revenue method thus usually records a larger liability for a loyalty program as compared to the incremental cost method. Basic journal entries can summarize key differences between the two methods (see Table 1).

ASC 606 AND AIRLINE ACCOUNTING

Airlines are expected to have a material impact on their financial statements after adoption of the new revenue recognition standard since ASC 606 calls for a contract-based approach that should be applied to transactions generating revenue, such that distinctive performance obligations can be identified and accounted for separately.

Under the new standard, airlines must separately account for any contract established with the customer. A

contract is defined as “an agreement between two or more parties that creates enforceable rights and obligations.”¹¹ Since it is usually clear that a contract exists between the airline and the customer calling for future travel through point redemption, revenue allocated to points must be deferred and recognized only when the performance obligation is satisfied or when the points expire without redemption.¹² Rules under ASC 606 resemble the deferred revenue approach. Hence, according to the FASB, the biggest impact of ASC 606 on airlines is the change in accounting for frequent-flyer programs.

Other impacts of ASC 606 on airlines include a change in the classification of ancillary fees in the financial statements and a change in the accounting for change fees. Under ASC 606, ancillary fees, including excess baggage, priority boarding, and dining services, will be reclassified. Although the recognition of these revenues will still be at the time of the flight, they will be reported under Passenger Revenue instead of Other Revenue. In addition, change fees will not qualify as a separate contract/performance obligation; as such, revenue from change fees will be recognized at the time of the flight and not when the fee is charged.¹³

Table 2: Relevant Airlines

Company Name	Ticker Symbol	CIK Number	Prior Loyalty Program Method
American Airlines Group Inc.	AAL	6201	Incremental Cost
Alaska Air Group Inc.	ALK	766421	Incremental Cost
Delta Air Lines Inc.	DAL	27904	Deferred Revenue
Southwest Airlines	LUV	92380	Incremental Cost
United Continental Holdings Inc.	UAL	100517	Deferred Revenue
Hawaiian Holdings Inc.	HA	1172222	Incremental Cost
Allegiant Travel Co.	ALGT	1362468	Incremental Cost
Spirit Airlines Inc.	SAVE	1498710	Incremental Cost

ASSESSING THE IMPACT

To analyze the impact of the implementation of ASC 606 by airlines, this study used the public filings of U.S. airlines submitting quarterly reports to the SEC. Since airlines do not disclose underlying calculations of financial statement figures, the study is restricted to publicly available numbers. Financial statements of a total of eight airlines have been analyzed (see Table 2).

The study focuses on predominantly passenger-based airlines with active loyalty programs. (Predominantly cargo-based carriers with no loyalty programs are excluded from the study even if they have been impacted by ASC 606.) All airlines analyzed in this study have implemented ASC 606 using the full retrospective method, recasting all prior year financial information to incorporate the effects of the new standard. The study analyzes adjustments to figures in the statement of operations of relevant airlines and aggregates the adjustments across all airlines for the six-month period ending June 30, 2017 (see Tables 3 and 4).

As shown in Table 4, ASC 606 did not have a material aggregate impact across the statements of operations of all airlines except for the decrease in Other Revenue by 48.12% after adjustments. This decrease is a direct impact of the reclassification of certain revenue from Other Revenue to Passenger Revenue, including ancillary fees. The aggregate net income of all airlines increased by approximately 2% after the implementation of the new standard.

At the individual airline level, most airlines were impacted similarly by the implementation. Six out of eight

airlines showed an adjustment greater than 40% for Other Revenue, with Delta showing an adjustment of more than 94% and Allegiant showing an adjustment of 100%. All airlines showed minimal change to net income, except for American; its net income increased by almost 26% after implementing the new standard.

Tables 5 and 6 show the adjustments to figures in the balance sheets of relevant airlines and aggregates the adjustments across all airlines as of December 31, 2017. As you can see, the most prominent impact of ASC 606 was the increase in the amount of loyalty program liability. Loyalty program liability increased by approximately 77% for the year ending December 31, 2017, after the implementation of the standard. This increase was because six of the eight airlines analyzed in this study shifted from the incremental cost model to the deferred revenue model.

Delta and United, which had been using the deferred revenue model before ASC 606 implementation, were impacted less significantly by the new standard. Although United showed minimal change to its program liability, Delta showed an increase of approximately 53% due to a change in the calculation of the fair value of miles, as required under the new standard. According to Delta's Form 10-Q, the airline "previously analyzed standalone sales of mileage credits to other airlines and customers to establish the accounting value for frequent-flyer miles. Under the new standard, it changed valuation of a mileage credit to an analysis of the award redemption value. The new valuation considers the quantitative value a passenger receives by re-

Table 3: ASC 606 Adjustments for Balance Sheet
(in \$ millions)

	AAL			ALK			LUV			UAL		
	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.
Operating Revenue	\$17,737	\$1,613	\$19,350	\$3,291	\$256	\$3,547	\$9,658	\$267	\$9,925	\$15,796	\$1,008	\$16,804
Passenger	368	42	410	313	(227)	86	—	—	—	474	37	511
Cargo	2,624	(1,337)	1,287	247	(38)	209	883	(309)	574	2,150	(1,031)	1,119
Other	20,729	318	21,047	3,851	(9)	3,842	10,541	(42)	10,499	18,420	14	18,434
Total Operating Revenue	(18,593)	50	(18,543)	(3,189)	(6)	(3,195)	(6,943)	17	(6,926)	(16,743)	15	(16,728)
Operating Expenses	(480)	—	(480)	(31)	—	(31)	(167)	—	(167)	(258)	(21)	(279)
Nonoperating Expenses	1,656	368	2,024	631	(15)	616	3,431	(25)	3,406	1,419	8	1,427
Income Before Taxes	(619)	(101)	(720)	(236)	6	(230)	(626)	10	(616)	(505)	(2)	(507)
Income Tax Provision	\$ 1,037	\$ 267	\$ 1,304	\$ 395	\$ (9)	\$ 386	\$2,805	\$ (15)	\$2,790	\$ 914	\$ 6	\$ 920
Net Income												

	HA			ALGT			SAVE			DAL		
	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.
Operating Revenue	\$1,131	\$57	\$1,188	\$433	\$282	\$715	\$372	\$309	\$681	\$16,919	\$1,027	\$17,946
Passenger	—	—	—	—	—	—	—	—	—	343	7	350
Cargo	159	(70)	89	277	(277)	—	329	(310)	19	2,677	(1,125)	1,552
Other	1,290	(13)	1,277	710	5	715	701	(1)	700	19,939	(91)	19,848
Total Operating Revenue	(1,080)	2	(1,078)	(29)	(4)	(33)	(569)	0	(569)	(16,858)	(9)	(16,867)
Operating Expenses	(29)	—	(29)	—	—	—	(9)	—	(9)	(275)	(26)	(301)
Nonoperating Expenses	181	(11)	170	681	1	682	123	(1)	122	2,806	(126)	2,680
Income Before Taxes	(64)	4	(60)	(54)	(0)	(54)	(46)	1	(45)	(979)	46	(933)
Income Tax Provision	\$ 117	\$ (7)	\$ 110	\$ 627	\$ 1	\$ 628	\$ 77	\$ (0)	\$ 77	\$ 1,827	\$ (80)	\$ 1,747
Net Income												

Table 4: Aggregated ASC 606 Adjustments for Statement of Operations
(in \$ millions)

	Orig.	Adj.	Recast.	% Change
Operating Revenue:				
Passenger	\$65,337	\$ 4,819	\$70,156	7.38%
Cargo	1,498	(141)	1,357	-9.41%
Other	9,346	(4,497)	4,849	-48.12%
Total Operating Revenue	76,181	181	76,362	0.24%
Operating Expenses	(64,004)	65	(63,939)	-0.10%
Nonoperating Expenses	(1,249)	(47)	(1,296)	3.76%
Income Before Taxes	10,928	199	11,127	1.82%
Income Tax Provision	(3,129)	(37)	(3,165)	1.17%
Net Income	\$ 7,799	\$ 162	\$ 7,962	2.08%

Table 5: ASC 606 Adjustments for Balance Sheet
(in \$ millions)

	AAL			ALK			LUV			UAL		
	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.
Deferred Tax Asset	\$ 427	\$ 1,389	\$1,816	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Other Assets	—	—	—	127	6	133	—	—	—	1,051	20	1,071
Deferred Tax Liability	—	—	—	454	(84)	370	2,358	(239)	2,119	225	(21)	204
Air Traffic Liability	3,978	64	4,042	937	(131)	806	3,460	35	3,495	3,876	64	3,940
Loyalty Program Liability	2,791	6,031	8,822	1,217	508	1,725	—	1,070	1,070	4,741	42	4,783
Loyalty Liabilities	—	—	—	451	(26)	425	1,777	(77)	1,700	569	7	576
Stockholders Equity (Deficit)	\$3,926	\$(4,706)	\$ (780)	\$4,454	\$(261)	\$4,193	\$14,621	\$(789)	\$13,832	\$8,806	\$(72)	\$8,734

	HA			ALGT			SAVE			DAL		
	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.	Orig.	Adj.	Recast.
Deferred Tax Asset	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 935	\$ 419	\$1,354
Other Assets	65	14	79	—	—	—	84	2	86	—	—	—
Deferred Tax Liability	174	(40)	134	118	1	119	313	(4)	309	—	—	—
Air Traffic Liability	545	44	589	210	(6)	204	246	17	264	4,888	(524)	4,364
Loyalty Program Liability	96	130	226	—	—	—	19	3	23	4,118	2,203	6,321
Loyalty Liabilities	146	1	147	—	—	—	—	—	—	3,969	120	4,089
Stockholders Equity (Deficit)	\$914	\$(121)	\$793	\$903	\$ 5	\$908	\$1,777	\$(15)	\$1,763	\$9,636	\$(1,380)	\$8,256

Table 6: Aggregated ASC 606 Adjustments for Balance Sheet
(in \$ millions)

	Orig.	Adj.	Recast.	% Change
Deferred Tax Asset	\$ 1,362	\$ 1,808	\$ 3,170	132.75%
Other Assets	1,327	42	1,369	3.15%
Deferred Tax Liability	3,643	(388)	3,255	-10.65%
Air Traffic Liability	18,141	(437)	17,704	-2.41%
Loyalty Program Liability	12,982	9,987	22,970	76.93%
Other Liabilities	6,912	25	6,937	0.37%
Stockholders Equity (Deficit)	\$45,037	\$(7,338)	\$37,699	-16.29%

deeming miles for a ticket rather than paying cash.”¹⁴

An indirect impact of the increase in the loyalty program liability was an increase in the amount of deferred tax assets (DTAs) or decrease in the amount of deferred tax liabilities (DTLs) since airlines deferred a larger amount than just the incremental cost under the new method and thus made tax payments in advance. Aggregate deferred tax assets increased by more than 130%. Delta’s DTA increased by close to 45%, whereas American’s DTA increased by about 325%. Aggregate DTL was reduced by 10.65%.

FUTURE IMPLICATIONS

These changes are significantly important to various users of the financial statements of these respective airlines. While calculating key revenue and expense-related ratios, investors must consider the impact of reclassifying ancillary fees and change fees from Other Revenue to Passenger Revenue. According to the FASB, this change will have an impact on key metrics such as passenger revenue per available seat mile.

In addition, since most airlines previously employed the incremental cost method to account for loyalty miles, stakeholders should be aware that there are significant changes relative to airline liabilities under respective loyalty programs. Stakeholders should also understand that accounting for airline loyalty programs will now be uniform across the industry in the United States, and revenue attributable to miles will not be

recognized until their redemption or expiration.

Consequently, redemption of miles awarded in prior years might lead to an increase in revenue in the current year, which should be kept in mind when reviewing an airline’s financial performance.

Future extensions of this study may incorporate annual changes after 2018. A relation between earnings and ASC 606 adjustments could also be developed. Year-over-year changes experienced by different airlines and comparison of the magnitude of the effect of ASC 606 on different airlines might be worthwhile to study, as might be the implementation of other FASB standards (such as the recently issued ASC 842, *Leases*) on airline entities. Future work may also include examining market/analyst reaction to changes implemented under ASC 606. ■

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ENDNOTES

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