

# In depth

## A look at current financial reporting issues



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## New revenue guidance Implementation in the transportation and logistics sector

### At a glance

Public companies must adopt the new revenue standards in 2018. Almost all companies will be affected to some extent by the new guidance, though the effect will vary depending on industry and current accounting practices. Although originally issued as a converged standard under US GAAP and IFRS, the FASB and IASB have made slightly different amendments, so the ultimate application of the guidance could differ under US GAAP and IFRS.

The Revenue Recognition Transition Resource Group (TRG) has discussed various implementation issues impacting companies across many industries. These discussions may provide helpful insights, and the SEC expects registrants to consider them in applying the new guidance.

This publication reflects the implementation developments over the past few years and highlights certain challenges specific to the transportation and logistics industry. The content in this publication should be considered with our global [Revenue guide](#), available at [CFODirect.com](#).

### Overview

The transportation and logistics industry includes companies associated with shipping, railways, airlines, trucking and logistics, and cruise lines. Customers generally pay a fee for the movement of cargo or passengers between two or more specified points. Customer incentives are limited, and primarily arise from volume discounts, or airlines' customer loyalty programs, in which awards are earned based on mileage flown and can be redeemed for a variety of products or services.

This publication discusses the areas in which the final revenue standards (ASC 606 and IFRS 15, *Revenue from Contracts with Customers*) are expected to have the greatest impact for companies in the transportation and logistics industry, broken down by step of the model.

## Scope

The new US GAAP and IFRS standards apply to all contracts with customers except for:

- Lease contracts
- Insurance contracts
- Certain contractual rights or obligations within the scope of other standards, including financial instrument contracts
- Certain guarantees (other than product warranties) within the scope of other standards
- Nonmonetary exchanges (between companies in the same line of business) to facilitate a sale to another party

Some contracts within the transportation and logistics industry may include components that are in the scope of the revenue standards and components that are in the scope of other standards (for example, a lease contract that also includes maintenance or other services). The new standards state that if a contract is partially within the scope of another standard, a company should apply any separation and/or measurement guidance in the other standard first. Otherwise, the principles in the revenue standards should be applied to separate and/or initially measure the component(s) of the contract.

The determination of whether an arrangement contains a lease might have significant accounting implications. Careful consideration of the relevant standard is required before applying the revenue standard to a contract. Contracts that involve providing or using fixed assets (for example, vessel time charters) might contain a lease. The boards issued new leasing standards that amend the guidance about what constitutes a lease. Management will need to carefully assess which arrangements or components of arrangements fall outside the scope of lease accounting and should be treated as revenue contracts.

The following discussion relates only to contracts and/or components of contracts that are within the scope of the revenue standard.



### 1. Identify the contract

A contract can be written, oral, or implied by a company's customary business practices. Generally, any agreement with a customer that creates legally-enforceable rights and obligations meets the definition of a contract. Legal enforceability depends on the interpretation of the law and could vary across legal jurisdictions where the rights of the parties are not enforced in the same way.

Transportation and logistics companies should consider any history of entering into amendments or side agreements to a contract that either change the terms of, or add to, the rights and obligations of a contract. These can be verbal or written, and could include cancellation, termination or other provisions. They could also provide customers with options or discounts, or change the substance of the arrangement. All of these have implications for revenue recognition. Therefore, understanding the entire contract, including any amendments, is important to the accounting conclusion.

As part of identifying the contract, companies are required to assess whether collection of the consideration is probable, which is generally interpreted as a 75-80% likelihood in US GAAP and a greater than 50% likelihood in IFRS. This assessment is made after considering any price concessions expected to be provided to the customer. In other words, price concessions are variable consideration (which affects the transaction price), rather than a factor to consider in assessing collectibility. Further, the FASB clarified in an amendment of ASC 606 that companies should consider, as part of the collectibility assessment, their ability to mitigate their exposure to credit risk, for example by ceasing to provide goods or services in the event of nonpayment. The IASB did not amend IFRS 15 on this point, but did include additional discussion regarding credit risk in the Basis for Conclusions of their amendments to IFRS 15.

New guidance	Current US GAAP	Current IFRS
<p>A company accounts for a contract with a customer when:</p> <ul style="list-style-type: none"> <li>• Contract has been approved and the parties are committed</li> <li>• Each party’s rights are identified</li> <li>• Payment terms are defined</li> <li>• Contract has commercial substance</li> <li>• Collection is probable</li> </ul>	<p>A company is generally prohibited from recognizing revenue from an arrangement until persuasive evidence of it exists, even if the other revenue recognition criteria have been met.</p> <p>Revenue is recognized when collectibility is reasonably assured.</p>	<p>A company is required to consider the underlying substance and economics of an arrangement, not merely its legal form.</p> <p>Management must establish that it is probable that economic benefits will flow before revenue can be recognized.</p>
<p>In evaluating whether an amount is collectible, management should consider whether a customer has the ability and intention to pay the promised consideration when it is due. The amount of consideration to which the company will be entitled may be less than the price stated in the contract if the consideration is variable. For example, the company may offer the customer a price concession.</p> <p>When collectibility of the transaction price is not probable at inception, management should continue to assess the contract each reporting period to determine if collectibility is probable. If collectibility of the transaction price is not probable and the company receives consideration from the customer, it should recognize the consideration received as revenue only when one of the following events has occurred:</p> <ul style="list-style-type: none"> <li>• There are no remaining obligations to transfer goods or services to the customer, and substantially all of the consideration has been received and is nonrefundable.</li> <li>• The contract has been terminated, and the consideration received is nonrefundable.</li> <li>• The company has transferred control of the goods or services to which the consideration received relates, the company has stopped transferring goods or services to the customer (if applicable) and has no obligation to transfer additional goods or services, and the consideration received is nonrefundable [US GAAP].</li> </ul> <p>The third criterion included in ASC 606 is intended to clarify when revenue should be recognized when it is unclear</p>	<p><i>Expected impact</i></p> <p>Today, companies that customarily obtain a written contract from their customers are precluded from recognizing revenue under US GAAP until there is a written and final contract signed by both the company and customer. The assessment of whether a contract with a customer exists under the new revenue guidance is less driven by the form of the arrangement, but whether an agreement between two parties (either written, oral, or implied) creates legally enforceable rights and obligations between them.</p> <p>The purpose of the collectibility assessment under the new guidance is to determine whether there is a substantive contract between the company and the customer. This differs from current guidance in which collectibility is a constraint on revenue recognition.</p> <p>The FASB’s amendment to the collectibility guidance, intended to narrow the population of contracts that fail the collectibility assessment, results in differences between US GAAP and IFRS. However, differences already existed in the original versions of the standards in this area because of the different definitions of “probable” in US GAAP and IFRS as discussed above. Based on the IASB’s clarifications in the Basis for Conclusions of their amendments and the fact that we expect the collectibility threshold to typically be met under both definitions, we do not expect a significant difference in financial reporting outcomes between US GAAP and IFRS in most cases.</p> <p>The new guidance also eliminates the cash-basis method of revenue recognition that is often applied today if collectibility is not reasonably assured (US GAAP) or probable (IFRS). Any cash received is recognized as a contract liability until either collectibility of the transaction price is probable or one of the criteria for recognition is met. This could result in revenue being recorded later than under current guidance in some situations.</p>	

New guidance	Current US GAAP	Current IFRS
<p>whether the contract has been terminated.</p> <p>IFRS 15 does not include the third criterion; however, the Basis for Conclusions indicates that a company could conclude a contract has been terminated when it stops providing goods or services to the customer, and therefore it is unlikely that the treatment under ASC 606 and IFRS 15 will be different.</p>		



## 2. Identify performance obligations

Many transportation and logistics companies provide multiple products or services to their customers as part of a single arrangement. Management must identify the separate performance obligations in an arrangement based on the terms of the contract and the company’s customary business practices. A bundle of goods and services might be accounted for as a single performance obligation in certain fact patterns.

New guidance	Current US GAAP	Current IFRS
<p>A performance obligation is a promise in a contract to transfer to a customer either:</p> <ul style="list-style-type: none"> <li>• A good or service (or a bundle of goods or services) that is distinct; or</li> <li>• A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.</li> </ul> <p>A good or service is distinct if both of the following criteria are met:</p> <ul style="list-style-type: none"> <li>• 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., it is capable of being distinct).</li> <li>• The good or service is separately identifiable from other goods or services in the contract (i.e., it is distinct in the context of the contract).</li> </ul> <p>Factors that indicate that two or more promises to transfer goods or services to a customer are not separately</p>	<p>The following criteria are applied to transactions to determine if elements included in a multiple-element arrangement should be accounted for separately:</p> <ul style="list-style-type: none"> <li>• The delivered item has value to the customer on a standalone basis.</li> <li>• If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.</li> </ul>	<p>The revenue recognition criteria are usually applied separately to each transaction. In certain circumstances, it might be necessary to separate a transaction into identifiable components to reflect the substance of the transaction.</p> <p>Two or more transactions might need to be grouped together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.</p>
	<p><b>Expected impact</b></p> <p>Assessing whether goods and services are capable of being distinct is similar to determining if deliverables have standalone value under existing US GAAP or are separate components under existing IFRS, although the definitions are not identical. Under the new guidance, management will assess if the customer can benefit from the good or service with “resources that are readily available to the customer,” which could be a good or service</p>	

New guidance	Current US GAAP	Current IFRS
<p>identifiable include (but are not limited to):</p> <ul style="list-style-type: none"> <li>The company provides a significant service of integrating the goods or services with other goods or services promised in the contract.</li> <li>One or more of the goods or services significantly modifies or customizes the other goods or services.</li> <li>The goods or services are highly interdependent or highly interrelated.</li> </ul> <p>ASC 606 states that a company is not required to separately account for promised goods or services that are immaterial in the context of the contract.</p> <p>IFRS 15 does not include the same specific guidance; however, IFRS reporters should consider the application of materiality concepts when identifying performance obligations.</p>	<p>sold separately by the company or another company, or a good or service the customer has already obtained.</p> <p>Companies will need to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item to which the promised goods or services are inputs. This will be a new assessment for companies as compared to today.</p>	

### Change fees

Change fees are common in the airline industry. The predominant industry practice under existing US GAAP is to account for change fees as a separate transaction independent of the original ticket sale and recognize revenue when the change occurs. In this case, change fees are viewed as a separate transaction because (1) the fees are charged subsequent to the initial sale, (2) passengers are not required to pay the fee at the time of the original sale, and (3) passengers who pay the fee receive an additional benefit.

An alternative view is that the change is not a separate transaction, but the result of the customer paying the lowest cost to obtain the new travel reservation (that is, paying the change fee instead of the price of a new ticket). Using this approach, the change fee is deferred and recognized when the travel occurs.

Under IFRS, practice today is mixed with some companies following the approach under US GAAP that the change fee is a separate transaction while others apply the alternative view.

Under the new standards, distinct goods or services are not transferred to the customer when a change fee is paid, so they do not represent a separate performance obligation. The only performance obligation in the contract (setting aside any loyalty points) is the flight, so change fees will be deferred and recognized when the flight occurs.



### 3. Determine transaction price

The transaction price is the consideration to which the company expects to be entitled in exchange for goods or services. Determining the transaction price may be simple when the contract price is fixed and paid at the time services are provided. However, it may require more judgment if the consideration contains an element of variable or contingent consideration. Common forms of variable consideration in the transportation and logistics industry include discounts, volume rebates and performance bonuses.

New guidance	Current US GAAP	Current IFRS
<p>The transaction price is the consideration that the entity expects to be entitled to in exchange for transferring promised goods or services to the customer. It includes fixed amounts and an estimate of variable consideration based on either the expected value or most likely amount approach (whichever is most predictive).</p> <p>Variable consideration (e.g., discounts and rebates) included in the transaction price is subject to a constraint. The estimated amount of variable consideration is included in the transaction price up to an amount that is probable (US GAAP) or highly probable (IFRS) of not resulting in a significant reversal of cumulative revenue in the future.</p> <p>Management will need to determine if there is a portion of the variable consideration (that is, a minimum amount) that would not result in a significant revenue reversal and include that amount in the transaction price. Determining the amount of variable consideration to record, including any minimum amounts, requires judgment.</p> <p>The revenue standards provide factors to consider when assessing whether variable consideration should be constrained.</p> <p>Management should reassess the estimate of variable consideration each reporting period. Customers may not exercise all of their contractual rights related to a contract, such as rebates and other incentive offers. These unexercised rights are often referred to as breakage. Management should adjust for changes in expectations when updating the estimated amount of consideration to which an entity expects to be entitled.</p>	<p>The seller's price must be fixed or determinable for revenue to be recognized. Rebates, other discounts, and incentives must be analyzed to conclude whether all of the revenue from the current transaction is fixed or determinable.</p> <p>Volume rebates are recognized as a reduction to revenue on a systematic and rational basis as progress by the customer toward earning the rebate occurs. The reduction is limited to the estimated amounts potentially due to the customer. If the rebate cannot be reliably estimated, revenue is reduced by the maximum potential rebate.</p>	<p>Revenue related to variable consideration is recognized when it is probable that the economic benefits will flow to the entity and the amount is reliably measurable, assuming all other revenue recognition criteria are met.</p> <p>Volume rebate payments are typically systematically accrued based on rebates expected to be taken. The rebate is recognized as a reduction of revenue based on the best estimate of the amounts potentially due to the customer. If the rebate cannot be reliably estimated, revenue is recognized at an amount no greater than the minimum consideration that the seller will retain.</p>
	<p><i>Expected impact</i></p> <p>The evaluation of variable consideration will require judgment in many cases. Some companies will need to recognize revenue before all contingencies are resolved, which might be earlier than under current practice. Management might need to put into place new processes to monitor estimates on an ongoing basis as more experience is obtained.</p>	

New guidance	Current US GAAP	Current IFRS
<p><i>Time value of money</i></p> <p>A company needs to adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component. Factors to consider when determining whether a contract has a significant financing component include, but are not limited to:</p> <ul style="list-style-type: none"> <li>• The expected length of time between when the company transfers the promised goods or services and when the customer pays for them</li> <li>• Whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction, and</li> <li>• The interest rate in the contract and prevailing interest rates in the relevant market.</li> </ul> <p>A significant financing component does not exist if the timing of delivery is at the customer's discretion (for example, in the case of customer loyalty points) or the difference between the promised consideration and the cash selling price arises for reasons other than financing.</p> <p>As a practical expedient, a company need not assess whether a contract has a significant financing component if it expects at contract inception that the period between payment and the transfer of services will be one year or less.</p> <p>If a contract with a customer contains a significant financing component, the company should measure the amount of the financing by using a discount rate that reflects a separate financing transaction between the company and its customer, and that factors in credit risk.</p>	<p>Discounting revenue is required in only limited situations, including for receivables with payment terms greater than one year.</p> <p>When discounting is required, the interest component is computed based on the stated rate of interest in the instrument or a market rate of interest if the stated rate is considered unreasonable.</p> <p><i>Expected impact</i></p> <p>The new guidance related to a significant financing component differs from current guidance on applying the time value of money. That said, we do not expect a significant change to current practice for most transportation and logistics companies in connection with the time value of money because payment terms do not often extend over more than one year from the time of contract performance.</p>	<p>Discounting revenue to present value is required when the arrangement effectively constitutes a financing transaction. The imputed rate of interest is the more determinable of either: (1) the prevailing rate on a similar instrument of an issuer with a similar credit rating, or (2) a rate that discounts the instrument to the current cash sales price of the goods or services.</p>

### *Example 3-1 – Demurrage claims in the transaction price*

**Facts:** A shipping company enters into a voyage charter contract with a customer to transport goods from point A to point B. The shipping company experiences delays in loading and unloading the cargo (referred to as demurrage), which are not the responsibility of the shipper. The additional amount to be paid to the shipping company is calculated in accordance with the terms of the contract. Demurrage claims are often negotiated, resulting in adjustments to the contract price, and can take a long time to resolve. When should the shipping company include the demurrage claim in the transaction price?

**Analysis:** Amounts for demurrage claims should not be included in the transaction price assessment prior to the occurrence of the delay as the company would not be entitled to claims prior to that point.

The amount of demurrage claims might be difficult to estimate and will vary depending on the counterparty and the type of delay. The shipping company may be familiar with the issues and have experience in successfully negotiating the claims. When delay occurs, the company should estimate the expected amount of the claim to be received and determine whether it is probable (US GAAP) or highly probable (IFRS) that there will not be a significant reversal of revenue in a future period. Although some or all of the claim may not meet this threshold, the company is required to include in the transaction price any portion of the claim that meets the probable/highly probable threshold. The time taken to resolve claims or the external factors involved are not factors that would allow the company to avoid including in the transaction price a minimum amount that meets the threshold.

The company should reassess its estimate of transaction price each reporting period.

### **Example 3-2 – Volume rebates**

**Facts:** A railway company enters into a contract to ship goods from point A to point B for \$1,000. The customer earns a rebate of \$100 for each load if the customer ships at least 10,000 loads annually. Based on past experience, management believes there is a 50% likelihood that the customer will ship 10,000 loads and earn the rebate of \$100 per load. How should the railway company determine the transaction price?

**Analysis:** The transaction price is \$900 per load, which reflects the amount to which the company expects to be entitled based on its estimate of loads to be shipped.

There are only two possible outcomes regarding the variable consideration (e.g., the rebate). The railway company will be entitled to either \$0 or an additional \$100 per load. It concluded that it would not be probable (US GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur if the incremental \$100 per load were included in the estimate of transaction price at inception.

Any amounts collected in excess of \$900 per load (that is, the additional \$100 per load prior to earning the rebate) would be recorded as a liability. These estimates should be monitored and adjusted, as necessary, using a cumulative catch-up approach. For instance, should circumstances change and it becomes probable (US GAAP) or highly probable (IFRS) that the customer will not be entitled to the rebate, the extra \$100 per load would be included in the transaction price for the loads previously shipped at that point.

### **Example 3-3 – Extended payment terms**

**Facts:** A tour operator sells a refundable tour with a limited number of spaces to a customer with a deposit due at the time of booking, which is 13 months before the tour. The ticket price is \$1,000, with \$100 paid at booking and the remainder due 90 days in advance of the tour. Alternatively, customers have the option to pay 100% at the time of booking; however, there is no discount for paying in full at the time of booking. How should the tour operator measure the transaction price of this contract?

**Analysis:** The tour operator should consider the purpose of the payment terms to determine whether there is a significant financing component in the contract. In this example, the tour operator might conclude that the amount charged at booking is not charged for the primary purpose of obtaining financing, but to reserve and hold the booking and space for the customer and to ensure the customer is committed to the reservation. The tour operator would therefore consider the \$1,000 to be the transaction price, and not account for a financing component.



## **4. Allocate transaction price**

Transportation and logistics companies may provide multiple goods or services to their customers as part of a single arrangement. Under the new standards, they will need to allocate the transaction price to the separate performance obligations in one contract based on the relative standalone selling price of each separate performance obligation.



## Customer loyalty programs — frequent flyer programs

Transportation and logistics companies often grant award credits (often called "points" or "miles") as part of sales transactions that can be redeemed for goods and services supplied either by the company itself or by other companies. The most common customer loyalty programs in the industry are the frequent flyer programs offered by airlines.

New guidance	Current US GAAP	Current IFRS
<p><i>Customer options that provide a material right</i></p> <p>A material right is a promise embedded in a current contract that should be accounted for as a separate performance obligation. If the option provides a material right to the customer, the customer, in effect, pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.</p> <p><i>Loyalty programs</i></p> <p>Credits issued under customer loyalty programs are separate performance obligations if they provide the customer with a material right that the customer would not receive without buying the initial product or service (for example, the original flight).</p> <p>The transaction price is allocated between the initial purchase and the award credits based on the actual or estimated standalone selling price of each performance obligation.</p> <p>The portion of the transaction price allocated to the award credits is not recognized as revenue until the credits are redeemed or expire.</p> <p>The standalone selling price of the award credits is not usually directly observable and will therefore need to be estimated. The estimate should reflect the discount achieved by customers when spending award credits, adjusted for the likelihood that the credits will be forfeited (breakage).</p> <p>The airline recognizes revenue from the award credits on a gross basis when the customer redeems them for goods or services that the airline provides.</p>	<p>Companies commonly follow two models to account for loyalty programs: the incremental cost model and the multiple-element model.</p> <p><i>Incremental cost model</i></p> <p>Revenue is recognized for the initial purchase (for example, the original flight) when it occurs. The cost of fulfilling award credits is treated as a future obligation and the related expense is accrued.</p> <p><i>Multiple-element model</i></p> <p>Consideration is allocated between the initial purchase and the award credits based on their relative fair values. Amounts allocated to the award credits are deferred and recognized as revenue when the award credits are redeemed or expire. The fair value of the award credits is not reduced for expected forfeitures (breakage).</p> <p>A company needs to determine whether it is acting as principal or agent in the arrangement based on certain indicators.</p> <p>Currently, three accounting models are generally accepted for the recognition of breakage. Breakage related to award credits expected to be forfeited is accounted for proportionally (1) as the awards are redeemed, (2) when the awards expire, or (3) when it becomes remote that the holder will demand performance.</p> <p><i>Expected impact</i></p> <p>Award credits issued under customer loyalty programs will be accounted for as separate performance obligations if they provide a material right to the customer. The incremental cost model will no longer be acceptable.</p>	<p>Customer loyalty programs are accounted for as multiple-element arrangements. Consideration is allocated to the award credits based on their fair values, typically using the residual method, although the guidance also permits relative fair values. This amount is deferred and recognized as revenue when the award credits are redeemed or expire.</p> <p>The fair value of the award credits is adjusted for discounts available to other buyers, absent entering into the initial purchase transaction and for expected forfeitures (breakage).</p> <p>Management needs to determine whether the company is acting as a principal or an agent in the arrangement. A company may be acting as an agent if it issues award credits that are transferred to and redeemed by other companies.</p> <p>Revenue is recognized net of payments made to others to redeem award credits if the company is acting as an agent.</p> <p>Airlines evaluate the value of status, if material, to determine whether it is a separate element for revenue considerations.</p> <p><i>Expected impact</i></p> <p>The new guidance will require consideration to be allocated on a relative standalone selling price basis, which could have a different result than the residual approach sometimes applied today. Some companies might allocate less consideration to the</p>

New guidance	Current US GAAP	Current IFRS
<p>An airline that operates a program in which points can be redeemed with a third party needs to consider whether it is the principal or an agent in the arrangement. This requires management to first consider the nature of its performance obligation.</p> <p>The company should recognize revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement.</p> <p><i>Tier status</i></p> <p>Customers can often obtain tier status on airlines due to frequent flyer programs which allow them to receive certain benefits (e.g., free checked baggage, potential upgrades, expedited boarding rights, etc.). Airlines may also grant tier status to individuals who can demonstrate they are frequent travelers (e.g., demonstrate status on other airlines). Tier status will give rise to a separate performance obligation if the status benefits provide a material right to the customer.</p> <p>In evaluating whether a material right exists, a company should consider the extent to which status benefits would also be available to individuals who have not achieved tier status with it.</p>	<p>Adjustments for expected forfeitures (breakage) will affect the timing of revenue recognition. The standalone selling price of award credits will be reduced to reflect the award credits not expected to be redeemed. This requirement could result in less revenue allocated to award credits as compared to today's multiple-element model.</p> <p>There is no guidance specific to tier status in current US GAAP. Judgment will be required in evaluating whether tier status provides the customer with a material right. Airlines will need to evaluate status benefits granted to customers, including the extent to which similar rights are generally available to individuals who have not completed similar prior purchases with the airline.</p>	<p>award credits under the new guidance as a result.</p> <p>Revenue allocated to award credits is recognized when the credits are redeemed or expire. Management will update its expectation of credits that will be redeemed each period to determine recognition of deferred amounts.</p> <p>Entities that currently only recognize revenue from points when they expire will likely recognize revenue earlier (based on estimated redemptions) under the new standard.</p>

### Example 4-1 – Frequent flier program

**Facts:** Airline A has a frequent flyer customer loyalty program that rewards customers with award credits based on amounts paid for flights. A customer purchases a ticket for \$500 (the standalone selling price) and earns 2,500 award credits based on the price of the ticket. Award credits are redeemable at a rate of 50 award credits for \$1 (\$0.02 per credit). The award credits may only be redeemed for flights with Airline A. How should the consideration be allocated between the award credits and the ticket (ignoring breakage)?

**Analysis:** The transaction price of \$500 should be allocated between the ticket and award credits based on the relative standalone selling prices of \$500 for the ticket and \$50 (2,500 points x \$0.02) for the award credits as follows:

Ticket	\$455 (\$500 x \$500/\$550)
Award credits	\$ 45 (\$500 x \$50/\$550)

Airline A would recognize revenue of \$455 when the flight occurs. It would defer revenue of \$45 and recognize it upon redemption or expiration of the award credits.

### Example 4-2 – Frequent flier program and breakage

**Facts:** Assume the same facts as in Example 4-1, except that Airline A expects redemption of 80% of award credits earned (that is, 20% breakage) based on the history of redemptions. The airline estimates a standalone selling price for

the credits of \$0.016 ( $\$0.02 \times 80\%$ ) based on the likelihood of redemption. How should the consideration be allocated between the award credits and the ticket (considering breakage)?

**Analysis:** The transaction price of \$500 should be allocated between the ticket and award credits based on the relative standalone selling prices of \$500 for the ticket and \$40 (2,500 points  $\times$  \$0.016) for the award credits as follows:

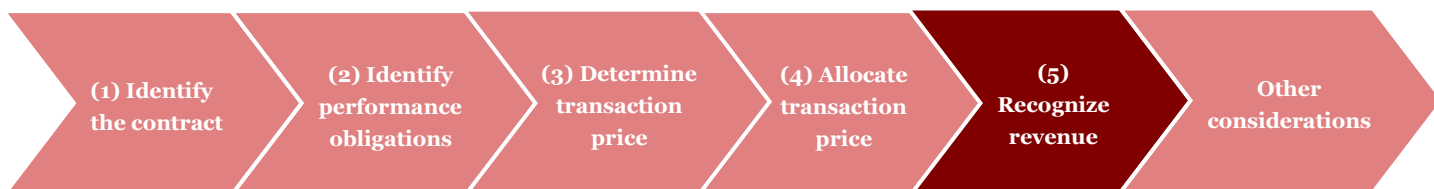
Ticket	\$463 ( $\$500 \times \$500/\$540$ )
Award credits	\$ 37 ( $\$500 \times \$40/\$540$ )

Airline A would recognize revenue of \$463 when the flight occurs. It would defer revenue of \$37 and recognize it when the 2,000 points (2,500 points  $\times$  80%) that are expected to be redeemed are redeemed by the customer or when the points expire.

### Example 4-3 – Frequent flier program - reassessing estimate of breakage

**Facts:** Assume the same facts as in Example 4-2. At the end of the first year, 1,000 points were redeemed out of the total 2,000 points expected to be redeemed, resulting in recognition of \$18.50 (50% of the \$37 deferred). In year 2, Airline A now expects redemption of 90% of award credits earned (that is, a total of 2,250 points). During the year, 500 points are redeemed. How much revenue should be recorded?

**Analysis:** Airline A should update the estimate of the number of awards that will be redeemed each reporting period and recognize revenue on a cumulative catch-up basis. Airline A should recognize revenue of \$6 in year 2, calculated as:  $[(1,500 \text{ points redeemed} / 2,250 \text{ points expected to be redeemed}) \times \$37 \text{ initial allocation}] - \$18.50$  recognized in the first year.



## 5. Recognize revenue and costs

Transportation or freight services are generally provided over a period of time ranging from one day to multiple years. The new standards require that revenue be recognized as a company satisfies a performance obligation by transferring control of a good or service. A performance obligation can be satisfied over time or at a point in time.

New guidance	Current US GAAP	Current IFRS
<p><b>Transportation revenue</b></p> <p>A performance obligation is satisfied over time if any one of the following criteria is met:</p> <ul style="list-style-type: none"> <li>The customer simultaneously receives and consumes the benefits as the company performs</li> <li>The company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced</li> <li>The company's performance does not create an asset with an alternative use, and the company</li> </ul>	<p>There are two predominant methods for recognizing revenue and costs for freight services:</p> <ol style="list-style-type: none"> <li>Recognize both revenue and direct costs when the shipment is completed, or</li> <li>Allocate revenue between reporting periods based on relative transit time in each period with costs recognized as incurred (the proportionate performance method).</li> </ol>	<p>Revenue is recognized for service transactions, such as freight services, based on the stage of completion of the transaction.</p> <p>Costs are recognized as incurred.</p>

New guidance	Current US GAAP	Current IFRS
<p>A company should recognize revenue over time only if the company can reasonably measure its progress toward complete satisfaction of the performance obligation.</p> <p>If a performance obligation is not satisfied over time, a company satisfies the performance obligation at a point in time. The standard provides indicators to determine the point in time at which control transfers.</p> <p><i>Transportation costs</i></p> <p>Costs to obtain or fulfill a contract are in the scope of the revenue guidance only if they are not addressed by other standards. Costs in the scope of other standards that are required to be expensed by those standards cannot be recognized as an asset under the revenue guidance.</p> <p>A company should recognize an asset for the incremental costs of obtaining a contract with the customer if the company expects to recover those costs. Incremental costs of obtaining a contract are those costs that the company would not have incurred if the contract had not been obtained (for example, sales commissions).</p> <p>A company should recognize an asset under the revenue guidance for costs to fulfill a contract when all of the following criteria are met:</p> <ul style="list-style-type: none"> <li>• The costs relate directly to a contract.</li> <li>• The costs generate or enhance resources of the company that will be used in satisfying performance obligations in the future.</li> <li>• The costs are expected to be recovered.</li> </ul> <p>Capitalized costs are amortized consistently with the pattern of transfer of control of the goods or services to which the asset relates. A company may elect, as a practical expedient, to expense the costs to obtain a contract as incurred when the expected amortization period is one year or less.</p>	<p><i>Expected impact</i></p> <p>Transportation services will likely meet the criteria for revenue recognition over time as the customer simultaneously receives and consumes the benefit as the entity performs. The boards observed that the customer benefits from the entity’s performance as it occurs if another entity would not need to substantially reperform the entity’s performance (for example, distance already travelled) to date. An entity should disregard any contractual or practical limitations when it assesses whether the customer simultaneously receives and consumes the benefits and whether another entity would need to substantially reperform the performance completed to date. For example, the assessment would not consider contractual provisions that restrict an entity from transferring its obligations to another entity.</p> <p>Freight fulfillment costs will continue to be expensed as incurred unless (1) they can be capitalized under another standard or (2) they relate directly to a contract or an anticipated contract, generate or enhance resources of the company that will be used in satisfying performance obligations in the future, and are expected to be recovered.</p>	

New guidance	Current US GAAP	Current IFRS
An impairment loss is recognized to the extent that the carrying amount of the capitalized asset exceeds the net amount of consideration to which the company expects to be entitled in exchange for the services to which the asset relates, less the remaining costs that relate directly to providing these services.		

### *Example 5-1 – Transportation contract revenue*

**Facts:** A shipping company enters into a contract with a customer to transport goods from point A to point B. The customer has an unconditional obligation to pay for the service when the service has been completed, which is when the goods reach point B. When should the shipping company recognize revenue from this contract?

**Analysis:** These types of contracts will typically meet the criteria for revenue recognition over time.

If the shipping company transports the goods halfway to the destination, another transportation company could fulfill the remaining obligation to the customer without having to reperform the services provided to date. The obligation to provide transportation services is therefore satisfied over time, and revenue should be recognized over the period of performance (generally the period from when transport of the goods begins from point A through delivery to point B).

### *Example 5-2 – Costs in inventory management services contract*

**Facts:** A logistics company enters into a contract to perform inventory management services for its customer over a two-year period. Mobilization costs are incurred in preparing to service the customer in accordance with the contract. These costs include leasehold improvements on warehouse space and internally-developed software related to software enhancements and customization required to perform under the contract. How should the logistics company account for these costs?

**Analysis:** The activities giving rise to these costs do not transfer a good or service to the customer. Management will therefore need to evaluate if the costs incurred to fulfill the contract are in the scope of other standards to determine if other standards require them to be expensed or capitalized. The accounting for the software costs is in the scope of the guidance for internally-developed software and should be evaluated in accordance with that guidance. Leasehold improvement costs fall under PP&E guidance and should be evaluated accordingly.

### *Example 5-3 – Transportation costs*

**Facts:** A shipping company has a vessel at point A and enters into a voyage charter contract with a customer to transport goods from point B to point C. The shipping company concludes that the contract does not contain a lease. Can the shipping company capitalize the costs to move the vessel from point A to point B?

**Analysis:** These costs do not fall under other guidance so the revenue standards would be applied. Judgment would be required to determine whether the costs to move the vessel (1) relate directly to a contract or to an anticipated contract that the company can specifically identify, (2) generate or enhance company resources that will be used in satisfying future performance obligations, and (3) are expected to be recovered. Assuming the costs meet these criteria, they would be capitalized.

### *Example 5-4 – Portfolio approach versus individual revenue recognition*

**Facts:** A container shipping company transports various customers' containers along a predetermined shipping route of around Port A, Port B, Port C, and back to Port A. The container shipping company concludes that the contract does not contain a lease. Different containers are loaded and unloaded at different ports. For example, one container is loaded at Port A and unloaded at Port C, another container is loaded at Port B and unloaded at Port C, and a third container is loaded at Port B and unloaded at Port A. Could the container shipping company recognize its transportation revenue from these three orders using a portfolio approach over the duration of the round-trip voyage or should it recognize revenue based on each individual voyage?

**Analysis:** The guidance may be applied to a portfolio of contracts (or performance obligations) with similar characteristics only if it reasonably expects that the effects of applying the portfolio approach would not differ materially from applying the new standards to the individual contracts. In the above example, we believe the container shipping company should account for its revenue based on the individual contracts with its customers.



## Principal versus agent (Gross versus net)

Some arrangements involve two or more unrelated parties that contribute to providing a specified good or service to a customer. In these instances, management will need to determine whether the company has promised to provide the specified good or service itself (as a principal) or to arrange for those specified goods or services to be provided by another party (as an agent). This determination often requires judgment, and different conclusions can significantly impact the amount and timing of revenue recognition.

Management should first understand the relationships and contractual arrangements among the various parties. This includes identifying the specified good or service being provided to the end customer and determining whether the company controls that good or service before it is transferred to the end customer. It is not always clear whether the company obtains control of the specified good or service. The revenue standards provide indicators to help management make this assessment.

New guidance	Current US GAAP	Current IFRS
<p>A company is the principal and should report revenue on a gross basis if it controls the specified good or service before it is transferred to the customer.</p> <p>Conversely, a company is an agent and should report revenue on a net basis if its obligation is to arrange for another party to provide goods or services (i.e., the company does not control the specified good or service before it is transferred to the customer).</p> <p>Indicators to assist companies in determining whether it controls the good or service before it is transferred to the customer are:</p> <ul style="list-style-type: none"> <li>The company is primarily responsible for fulfilling the promise</li> <li>The company has inventory risk</li> <li>The company has discretion in establishing the price</li> </ul>	<p>Current US GAAP provides indicators to determine whether gross or net reporting is more appropriate. The indicators that support gross reporting is appropriate are:</p> <ul style="list-style-type: none"> <li>The company is the primary obligor in the arrangement</li> <li>The company has general inventory risk</li> <li>The company has latitude in establishing pricing</li> <li>The company changes the product or performs part of the service</li> <li>The company has discretion in supplier selection</li> <li>The company is involved in determining product or service specifications</li> <li>The company has physical loss inventory risk</li> <li>The company has credit risk</li> </ul> <p>The following indicators suggest net reporting is appropriate:</p>	<p>A company is acting as principal when it is exposed to the overall risks and rewards of the transaction. It presents revenue gross if the gross economic benefit from the business activity results in an increase in the company's equity.</p> <p>Alternatively, the company presents revenue net if the gross economic inflows include amounts collected on behalf of the principal.</p> <p>The following are indicators to assess in determining whether gross or net revenue presentation is appropriate:</p> <ul style="list-style-type: none"> <li>Primary responsibility for providing the goods or services</li> <li>Inventory risk</li> <li>Latitude in establishing price</li> <li>Credit risk</li> </ul>

New guidance	Current US GAAP	Current IFRS
<p>Under the new standards, no single indicator is determinative or weighted more heavily than others. However, some indicators may provide stronger evidence, depending on the circumstances.</p> <p>The principal versus agent assessment is performed at the performance obligation level, not at the contract level. A company may act as a principal with respect to certain performance obligations in the contract and an agent with respect to others.</p>	<ul style="list-style-type: none"> <li>• The company's supplier is the primary obligor in the arrangement</li> <li>• The amount the company earns is fixed</li> <li>• The company's supplier has credit risk</li> </ul> <p>Being the primary obligor and having inventory risk are considered stronger indicators in the analysis.</p>	
	<p><i>Expected impact</i></p> <p>Although the indicators in the new standards are similar to those in the current guidance, the purpose of the indicators is different. The new standards require a company to assess whether it controls the specified good or service, and the indicators are intended to support the control assessment. In contrast, the existing guidance is focused on assessing whether the company has the risks and rewards of a principal. Companies will therefore need to reassess their arrangements through the lens of the control principle.</p> <p>The new standards also provide more guidance on the unit of account that should be used in the gross versus net assessment, which could result in changes to the assessment as compared to current guidance.</p>	

### *Example 6-1 – Principal versus agent assessment*

**Facts:** A customer purchases a ticket to fly from point A to point C from Airline Y, with a stop at point B. Airline Y will operate the flight from point A to point B and Airline Z will operate the flight from point B to point C. At the time of booking, the customer is aware that Airline Z will operate the second segment of the flight, and while Airline Y has latitude to price the entire ticket, it does not bear any inventory risk over seats on Airline Z's plane. Airline Y has concluded that each flight segment is a separate performance obligation. Should Airline Y record revenue as a principal or as an agent in this transaction?

**Analysis:** For each performance obligation, Airline Y should determine whether its promise is to provide a service (as a principal) or to arrange for a third party to provide services (as an agent).

For the first flight segment, Airline Y concluded that revenue should be recorded on a gross basis as it is the only company involved in providing the flight service from point A to point B.

Conversely, for the second flight segment, Airline Y may conclude that it has merely arranged for Airline Z to provide the flight and should report revenue on a net basis (e.g., reflecting only its fee from Airline Z as revenue for arranging the carriage). If Airline Y has no inventory risk and is not primarily responsible for fulfilling the promise to fly the customer from point B to point C, it may indicate that Airline Y does not control the service before it is transferred to the customer.

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