Practical guide to IFRS

Revenue recognition re-exposed ED – implications for transport & logistics industry

November 2011

Overview

The Transportation and Logistics industry includes entities associated with four primary modes of transportation: shipping, railways, airlines, and trucking and logistics. Customers generally pay a fee for the movement of cargo or passengers between two or more specified points. Customer incentives are primarily in the form of volume discounts, or for airlines, customer loyalty programmes where awards are earned based on mileage flown and can be redeemed for a variety of products or services.

The accounting for common transactions in the transportation industry may be affected by the proposed revenue recognition standard. This publication, including the examples and related assessments, is based on the exposure draft, 'Revenue from contracts with customers', issued on November 14, 2011. The proposed standard is subject to change until a final standard is issued. The examples reflect the potential effects of the proposed standard, pending further interpretation and assessment based on the final standard. For a more comprehensive description of the model, refer to PwC's 'Practical guide' or visit www.fasb.org or www.ifrs.org.

Scope

Some contracts within the transportation industry may include components that are in the scope of the revenue standard and components that are in the scope of other standards (for example, a lease contract that also includes maintenance or other services). The proposed revenue standard applies 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; and
- Non-monetary exchanges (between entities in the same line of business) to facilitate a sale to another party.

The proposed revenue standard states that if a contract is partially within the scope of another standard, an entity applies the separation and/or measurement requirements of the other standard first if that standard specifies how to separate or measure components of a contract. Otherwise, the principles in the revenue standard are applied to separate and/or initially measure the part(s) of the contract.

The determination of whether an arrangement contains a lease might have significant accounting implications. Careful consideration of the appropriate standard to follow is warranted before applying the revenue standard to a contract. Contracts that involve providing or using fixed assets (for example, vessel charters) might contain a lease component. Management will need to assess whether the contract is or contains a lease and then determine whether the lease component should be accounted for separately from any service component. The boards are currently

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redeliberating a new lease model that we expect will be effective at the same time as the new revenue standard.

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

Transportation revenue and costs

Transportation or freight services are generally provided over a period of time ranging from a day to several months. The proposed standard includes a control transfer model for recognising revenue. Revenue is recognised as an entity satisfies a performance obligation by transferring control of a good or service. A performance obligation might be satisfied over time or at a point in time.

<table>
<tr><th>Proposed standard</th><th>Current US GAAP</th><th>Current IFRS</th></tr>
<tr>
<td rowspan="2">Transportation revenue

A performance obligation is satisfied over time if the entity’s performance creates or enhances an asset the customer controls, or the entity's performance does not create an asset with alternative future use to the entity, and any one of the following apply:
• The customer simultaneously receives and consumes a benefit as the entity performs;
• Another entity would not need to substantially re-perform any work completed to date if another entity were required to fulfil the remaining obligation to the customer; or
• The entity has a right to payment for performance to date and expects to fulfil the contract as promised.

An entity should recognise revenue over time only if the entity can reasonably measure its progress towards satisfaction of the performance obligation.

Transportation costs

Incremental costs incurred to obtain a contract should be recognised as an asset if they are expected to be recovered. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained (for example, sales commissions).</td>
<td>There are two predominant methods for recognising revenue and costs for freight services:
(1) recognise both revenue and direct costs when the shipment is completed; or
(2) allocate revenue between reporting periods based on relative transit time in each period with costs recognised as incurred (the proportionate performance method).</td>
<td>Revenue is recognised for service transactions, such as freight services, based on the stage of completion of the transaction. Costs are recognised as incurred.</td>
</tr>
<tr>
<td colspan="2">Impact
Transportation services will meet the criteria for revenue recognition over time when the work completed to date would not need to be re-performed. It is not necessary that the contract permit an entity to transfer a performance obligation to another entity.

Freight fulfilment costs will continue to be expensed as incurred unless (a) they can be capitalised under another standard; or (b) they relate directly to a contract, relate to future performance, and are expected to be recovered. Where revenue is recognised over time, it is unlikely that fulfilment costs will be capitalised under the proposed standard.</td>
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</table>

Proposed standard	Current US GAAP	Current IFRS
An entity is permitted to recognise contract acquisition costs as an expense as incurred if the amortisation period would be a period of one year or less, as a practical expedient. Costs to fulfil 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 recognised as an asset under the revenue guidance. An entity should recognise an asset under the revenue guidance only if the costs relate directly to a contract will generate or enhance a resource that the entity will use to satisfy future performance obligations in a contract, and are expected to be recovered under a contract. The costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate to a specific anticipated contract. The costs of abnormal amounts of wasted materials, labour, or other resources that were not reflected in the price of the contract should be recognised as an expense when incurred. Capitalised costs are then amortised consistently with the pattern of transfer of control of the goods or services to which the asset relates.		

Example 1

Facts: A shipping entity 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 performed, which is when the goods reach point B. When should the entity recognise revenue from this contract?

Discussion: These types of contracts will typically meet the criteria for revenue recognition over time. If the shipping entity transports the goods halfway to their destination, another transportation entity could fulfil the remaining obligation to the customer without having to re-perform the services provided to date (even if the obligation could not be transferred legally or if it would be unlikely because of the cost of changing vendors). The obligation to provide transportation services is therefore satisfied over time, and revenue should be recognised over the period of performance.

Example 2

Facts: A logistics entity enters into a contract to perform inventory management services for its customer over a two-year period. Mobilisation costs are incurred in preparing to service the customer in accordance with the contract. These costs include employee training, leasehold improvements on warehouse space, and internally developed software related to software enhancements and customisation to perform under the contract. How should these costs be accounted for?

Discussion: Management will first need to evaluate if the costs incurred to fulfil the contract are in the scope of other standards to determine if the costs must be expensed or capitalised under the other standard. The accounting for the internally developed software costs is in the scope of the guidance for internally developed software costs and will be evaluated in accordance with that guidance. Leasehold improvement costs fall under PP&E guidance and are evaluated accordingly. The training costs fall under IAS 38, 'Intangible assets', for IFRS reporters and would be expensed as costs cannot be capitalised under the revenue standard if they must be expensed under other applicable standards.

US GAAP does not have a standard that specifically covers training costs, These costs would be evaluated in accordance with the guidance in the revenue standard. These costs to fulfil a contract would be eligible for capitalisation so long as they: (a) relate directly to the contract; (b) generate or enhance resources that will be used to satisfy future performance obligations; and (c) are probable of recovery.

Customer loyalty programmes – frequent flyer programmes

Transportation and logistics entities such as airlines often grant award credits (often called 'points' or 'miles') as part of sales transactions, including award credits that can be redeemed for goods and services supplied by other entities. The most common customer loyalty programmes in the industry are the frequent flyer programmes offered by airlines.

Proposed model	Current US GAAP	Current IFRS
Credits issued under customer loyalty programmes are separate performance obligations if they provide the customer with a material right that the customer would not receive without entering into the transportation contract. The transaction price is allocated between the initial flight and the award credits based on the actual or estimated standalone selling price of each obligation. Revenue relating to the award credits is deferred until the obligation is satisfied (that is, when the award credits are redeemed or expire). The standalone selling price for a customer's option to acquire additional goods or services (loyalty	There is divergence in practice in the accounting for loyalty programmes. Two models commonly followed are the incremental cost model and the multiple-element model. Many entities use the incremental cost model, whereby revenue is recognised for the flight when the flight occurs. The cost of fulfilling award credits is treated as an expense and accrued. Other entities use the multiple-element model and allocate revenue to the award credits based on relative fair values. Revenue allocated to the award credits is deferred and recognised when the award credits are redeemed or expire. The fair value of the award credits is not reduced for expected forfeitures (breakage).	Customer loyalty rogrammes are accounted for as multiple-element arrangements. Revenue allocated to the award credits is deferred and recognised when the award credits are redeemed or expire. 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). Management determines whether the entity is acting as a principal or an agent in the arrangement. An entity may be acting as an agent if it issues award credits that are transferred to and redeemed by other entities. Revenue is recognised net of payments made to others to redeem award credits

Proposed model	Current US GAAP	Current IFRS
awards) is not usually directly observable and may be estimated. That estimate should reflect the discount the customer would obtain when exercising the option, adjusted for discounts readily available without the option and the likelihood that the option will be forfeited (breakage). The airline recognises revenue from the award credits on a gross basis when the airline redeems the award credits for goods or services that it provides. The airline recognises revenue for the net amount retained when the airline arranges for another party to provide those goods or services.	An entity determines whether it is acting as a principal or an agent in the arrangement based on certain criteria. Breakage related to award credits expected to be forfeited is accounted for either proportionally as the awards are redeemed or when the awards expire.	if the entity is acting as an agent.
	Impact Award credits issued under customer loyalty programmes will likely be accounted for as separate performance obligations and the incremental cost model will no longer be acceptable. 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. The accounting for breakage will result in earlier revenue recognition for entities that apply the multiple-element model today. Management will need to determine whether the entity is acting as a principal or an agent when delivering the underlying goods or services upon redemption of award credits. An entity might be acting as an agent if it issues award credits that are transferred to and redeemed by other entities. The entity will recognise revenue from the award credits net of payments made to other parties in these situations. These changes will align the accounting for customer loyalty programmes under US GAAP with IFRS.	***Impact*** The proposed standard is consistent with the current IFRS guidance and the effect will therefore be limited.

Example 3

Facts: Airline A has a frequent flyer customer loyalty programme that rewards customers with one award credit for each mile flown. A customer purchases a ticket for C500 (the standalone selling price) and earns 2,500 award credits based on mileage flown. Award credits are redeemable at a rate of 25,000 award credits for one free travel award, which has an average value of C500 (C0.02 per credit). The award credits may only be redeemed for flights with Airline A. How is the consideration allocated between the award credits and the ticket (ignoring breakage)?

Discussion: The transaction price of C500 is allocated between the ticket and award credits based on the relative standalone selling prices of C500 for the ticket and C50 (2,500 points x C0.02) for the award credits as follows:

Ticket:	C455 (C500 x C500/C550)
Award credits:	C45 (C500 x C50/C550)

Revenue of C455 is recognised when the flight occurs. Revenue of C45 is recognised upon the earlier of the redemption of the travel award or expiration of the award credits.

Example 4

Facts: Assume the same facts as in Example 3 above, except that the airline expects redemption of 80% of award credits earned (that is, 20% breakage) based on the airline's history. The airline estimates a standalone selling price for the credits of C0.016 (C0.02 x 80%) based on the likelihood of redemption. How is the consideration allocated between the award credits and the ticket?

Discussion: The transaction price of C500 is allocated between the ticket and award credits based on the relative standalone selling prices of C500 for the ticket and C40 (2,500 points x C0.016) for the award credits as follows:

Ticket:	C463 (C500 x C500/C540)
Award credits:	C37 (C500 x C40/C540)

Revenue of C463 is recognised when the flight occurs. Revenue of C37 is recognised upon the earlier of the redemption of the travel award or expiration of the award credits.

Example 5

Facts: Assume the same facts as in Example 4 above, except that the award credits can be redeemed for services not provided by the airline. The airline pays other participating entities the value of the award credits less a 10% commission when the award credits are redeemed for products or services not provided by the airline. How much revenue is recognised upon the redemption of the award credits assuming all credits are redeemed by other entities?

Discussion: Revenue of C3.70 (10% of C37) is recognised upon the redemption of the award credits for products not provided by the airline. The entry when the award credits are redeemed is as follows:

Dr. Contract Liability	C37.00	
Cr. Revenue		C3.70
Cr. Cash		C33.30

Onerous performance obligations

The proposed standard requires that performance obligations satisfied over a period of time greater than one year be assessed to determine whether a loss will be incurred relating to that obligation.

<table>
<tr><th>Proposed model</th><th>Current US GAAP</th><th>Current IFRS</th></tr>
<tr><td rowspan="2">Management will need to assess whether performance obligations satisfied over a period greater than one year are onerous. A provision for an onerous performance obligation is recorded if the lowest cost of settling the performance obligation exceeds the transaction price allocated to that performance obligation.</td><td>Anticipated losses on executory contracts generally should not be recognised.</td><td>Contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received are onerous; thus, an onerous provision is recognised.</td></tr>
<tr><td colspan="2">Impact
Management will need to evaluate services performed over a period greater than a year will need to be evaluated to determine if the performance obligation is onerous.</td></tr>
</table>

Change fees

Change fees are common in the airline industry. The predominant industry practice under US GAAP and IFRS is to account for change fees as a separate transaction independent of the original ticket sale and recognise revenue when the change occurs. Change fees are viewed as a separate transaction because the fees are charged subsequent to the initial sale, passengers are not required to pay the fee at the time of the original sale, and 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). The change fee is deferred and recognised when the travel occurs when following this view under current guidance.

The proposed standard will require management to consider whether the change fee should be accounted for as a separate contract or as a modification of the original contract. Change fees do not appear to meet the criteria to be accounted for as a separate contract as they do not typically result in the delivery of an additional distinct good or service for a standalone selling price. They are likely to be a contract modification that results in a change in transaction price and at times, also a change in the service to be delivered. The change fee would likely not be accounted for as a separate contract and would likely be accounted for as a modification of the original sales transaction and recognised when the travel occurs.

Collectibility

Collectibility refers to the risk that the customer will not pay the promised consideration. Collectibility will no longer be a hurdle to revenue recognition as it is under today's guidance.

Proposed model	Current US GAAP	Current IFRS
Any expected impairment loss due to credit risk will be presented in a separate line item adjacent to the revenue line. Both the initial assessment and any subsequent changes in the estimate of bad debt expense will be recorded in this line.	Revenue is recognised when payment is reasonably assured (or probable). Credit risk is reflected as a reduction of accounts receivable by recording an increase in the allowance for doubtful accounts and bad debt expense, which is usually recorded as a general and administrative expense.	Management must establish that it is probable that economic benefits will flow before revenue can be recognised. Provision for bad debts (incurred losses on financial assets including accounts receivable) is recognised in a two-step process: (a) objective evidence of impairment must be present; then, (b) the amount of the impairment is measured based on the present value of expected cash flows. The expense is usually recorded as a general and administrative expense.
	Impact Revenue may be recognised earlier than current practice since collectibility will no longer be a recognition threshold. Customers' credit risks will reduce gross profit.	

Variable consideration

Determining the transaction price is simple when the contract price is fixed and paid at the time services are provided. Determining the transaction price may require more judgment if the consideration contains an element of variable or contingent consideration. Common issues for the transportation and logistics industry include the accounting for volume discounts and performance bonuses. Many transportation and logistics entities

	offer discounts for shipping a specified cumulative volume or shipping to or from specific locations. Discounts	based on volume or other factors are variable consideration under the proposed standard.

<table>
<tr><th>Proposed model</th><th>Current US GAAP</th><th>Current IFRS</th></tr>
<tr><td rowspan="2">Volume discounts

Volume discounts are generally receivable by the customer when specified cumulative levels of revenue are earned.

The transaction price is the consideration that the entity expects to be entitled to receive under the contract, including variable or uncertain consideration. It is based on either the probability-weighted estimate or most likely amount of cash flows expected from the transaction, depending on which is the most predictive of the amount to which the entity would be entitled.

If an entity receives consideration from a customer and expects to refund some or all of that consideration, a liability should be recognised for the amount of consideration that the entity expects to refund.

Revenue is recognised as a performance obligation is satisfied but only if an entity is reasonably assured to be entitled to the amount allocated to that performance obligation.

An entity is reasonably assured to be entitled to an amount when it has experience with similar contracts (or has other persuasive evidence such as access to the experience of other entities with similar contracts) and the entity's experience is predictive.</td><td>Volume rebates are recognised as a reduction to revenue as the customer earns the rebate. The reduction is limited to the estimated amounts potentially due to the customer. If the discount cannot be reliably estimated, revenue is reduced by the maximum potential rebate.</td><td>Volume discount payments are systematically accrued based on discounts expected to be taken. The discount is then recognised as a reduction of revenue based on the best estimate of the amounts potentially due to the customer. If the discount cannot be reliably estimated, revenue is reduced by the maximum potential rebate.</td></tr>
<tr><td colspan="2">Impact
Accounting for most volume discounts is unlikely to be significantly different under the proposed standard compared to today's accounting (US GAAP and IFRS). The accounting for contracts with downward tiered pricing based solely on volume may, however, be different from current US GAAP.</td></tr>
<tr><td>Time value of money

An entity will adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component.

As a practical expedient, an entity need not assess whether a contract has a significant financing component if the entity expects at contract</td><td>The discounting of revenues is required in only limited situations, including receivables with payment terms greater than one year.

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</td><td>Discounting of revenues to present value is required where the effect of discounting is material. An imputed interest rate is used to determine the amount of revenue to be recognised, as well as the separate interest income component to be recorded over time.</td></tr>
</table>

Proposed model	Current US GAAP	Current IFRS
inception that the period between payment by the customer and the transfer of the services to the customer will be one year or less. Management uses a discount rate that reflects a separate financing transaction between the entity and its customer, and factors in credit risk.	unreasonable. ***Impact*** The proposed standard is not significantly different from today's guidance. We do not expect a significant change to current practice for most transportation and logistics entities in connection with the time value of money, because payment terms often do not extend over more than one year from the timing of contract performance.	

Example 6

Facts: A railway entity enters into a contract to ship goods from point A to point B for C1,000. The customer earns a discount of C100 per load if the customer ships at least 10,000 loads annually. Based on past experience, management believes that it is probable that the customer will ship 10,000 loads and earn the discount of C100 per load. How should the railway entity record revenue from this contract?

Discussion: The railway entity will record revenue of C900 per load based on the most likely amount of consideration it expects to be entitled to. Any excess amounts paid (that is, the additional C100 per load prior to earning the discount) are recorded as a refund liability. This estimate is monitored and adjusted, as necessary, using a cumulative catch-up approach.