

STAFF PAPER

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Project	Compensation for delays or cancellations (IFRS 15)		
Paper topic	Initial Consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the accounting for an airline's obligation to compensate customers for delayed or cancelled flights. Legislation stipulates customers' rights to receive compensation.
2. The objective of this paper is to:
 - (a) provide the Committee with a summary of the matter;
 - (b) present our research and analysis; and
 - (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:
 - (a) background information (paragraphs 5–9);
 - (b) outreach (paragraph 10);
 - (c) staff analysis (paragraphs 11–35); and
 - (d) staff recommendation (paragraphs 36–37).

4. There are two appendices to this paper:
 - (a) Appendix A—proposed wording of the tentative agenda decision; and
 - (b) Appendix B—submission.

Background information

5. Appendix B to this paper includes the submission. The main facts we considered in our analysis are as follows:
 - (a) legislation gives a flight passenger (customer) the right to be compensated by the flight provider (entity) for delays, cancellations and denied boarding subject to specified conditions in the legislation. The legislation stipulates the amount of compensation, which is a lump-sum amount unrelated to the amount the customer pays for the flight.
 - (b) the legislation creates enforceable rights and obligations, and forms part of the terms of the contract between the entity and its customers.
 - (c) a contract to provide a flight to a customer is within the scope of IFRS 15 *Revenue from Contracts with Customers* for the entity. Applying IFRS 15, the entity identifies as a performance obligation its promise to transport the customer from one specified location to another.
6. The submitter asks whether the entity accounts for its obligation to compensate customers as described in the submission either:
 - (a) as part of the transaction price; or instead
 - (b) as an obligation accounted for applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
7. The submitter says it has observed both approaches in practice.
8. The submitter notes that it is not asking either of the following that might also arise in the context of delayed or cancelled flights:
 - (a) how to account for refunds of the ticket price or price modifications that may occur in addition to paying compensation stipulated by law.

- (b) if treated as part of the transaction price, whether the amount of compensation recognised as a reduction of revenue is limited to reducing the transaction price to nil (with any remainder being recognised as an expense).
9. Accordingly, we have focussed our analysis only on the question in the submission.

Outreach

10. We decided not to perform outreach on this topic. This is because our research identified publicly available financial statements of airlines that explain within their accounting policies how they account for compensation for delays and cancellations. Accordingly, we are aware that the compensation described in the submission is at least prevalent in the airline industry and could have a material effect on those entities affected.

Staff analysis

11. The question in the submission relates to Step 3 of the revenue recognition model in IFRS 15—determining the transaction price. Nonetheless, before analysing that question we think it is helpful to comment on ‘the terms of the contract’ as described in the submission.

The terms of the contract

12. The submission indicates that the enforceable rights and obligations created by the legislation form part of the contract between the entity and its customers. We agree with this conclusion in the context of the application of IFRS 15.
13. Paragraph 10 of IFRS 15 states that:
- A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law.

Contracts can be written, oral or implied by an entity's customary business practice...

14. In the facts described in the submission, on purchasing a flight ticket (and thus entering into a contract for a flight with the entity), a customer obtains an enforceable right to compensation if the flight is delayed or cancelled. If that right to compensation were explicitly written in the contract, the entity would clearly consider it to be an embedded part of that contract. Similarly, in the facts described in the submission, the entity considers the customer's right to compensation to be part of the contract with the customer. The fact that legislation stipulates the customer's right to compensation does not change the enforceable rights and obligations that arise on entering into the contract for a flight. The contract incorporates the enforceable right under the law, regardless of whether the contract with the customer explicitly refers to the legislation.

What does IFRS 15 say about determining the transaction price?

15. Paragraph 2 of IFRS 15 sets out the core principle of the Standard, which is that:

An entity shall recognise 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.

16. Paragraph 47 specifies the following regarding the transaction price:

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer...The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

17. Paragraphs 50–65 of IFRS 15 specify requirements for variable consideration. Paragraph 50 states that 'if the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the

entity will be entitled in exchange for transferring the promised goods or services to a customer'. The transaction price includes an estimate of variable consideration (subject to the constraint described in paragraphs 56–58). Paragraph 51 lists examples of common types of variable consideration—‘discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items’.

18. Paragraphs B28–B33 set out requirements regarding warranties and, in particular, paragraph B33 discusses compensation stipulated by law for harm or damage caused by an entity’s products:

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity’s promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark or other infringement by the entity’s products does not give rise to a performance obligation. The entity shall account for such obligations in accordance with IAS 37.

Is the obligation to compensate the customer variable consideration or an obligation as described in paragraph B33?

19. The submitter asks whether the entity accounts for its obligation to compensate customers for delayed or cancelled flights either as (a) variable consideration that forms part of the transaction price; or (b) as an obligation applying the requirements in paragraph B33 (see paragraph 18 above).
20. The answer to this question could affect not only the amounts recognised in the entity’s balance sheet for the obligation but also the amounts recognised in profit or loss. This is because:
 - (a) if the obligation is part of the transaction price, it could affect the amount of revenue recognised by the entity, whereas

(b) if the obligation is accounted for applying IAS 37 (separately from the entity's promise to provide a flight service), it would affect the expenses recognised by the entity, but not revenue.

21. To answer the question, we think it is important to consider the performance obligation in the contract—in other words, what has the entity promised the customer? Has the entity promised to transport the customer from one specified location to another by a specified time on a particular date? Or instead has the entity made no promise regarding the time and date, but separately agreed to compensate the customer for damage or harm caused?

The entity's promise is to transport the customer by a specified time on a particular date

22. The submitter notes that some view compensation for delays and cancellations as a separate obligation as described in paragraph B33 of IFRS 15. Those supporting this view note that airlines do not guarantee flight times—therefore, any compensation paid does not relate to the entity's performance but is compensation for harm or damage as described in paragraph B33.
23. We disagree with this view. We think the entity promises to transport the customer from one specified location to another by a specified time on a particular date. We agree that the entity does not promise to transport the customer at the exact scheduled flight time. Nonetheless the existence of the legislation means that the entity has promised to transport the customer within a specified time period after that scheduled flight time (for example, within five hours of the scheduled flight time). If the entity fails to do so, the customer has the right to compensation.
24. We view compensation for a delayed flight as no different from penalties in a construction contract for delayed completion of the construction. In such a contract, penalties are payable by the construction entity for failure to transfer the constructed good or construction service by a specified date. The construction entity's performance obligation is not only to transfer the constructed good or construction service but, rather, to transfer that good or service by a specified date.

25. In that situation, the construction entity would consider any penalties to be variable consideration in the contract. Paragraph 51 of IFRS 15 lists ‘penalties’ as an example of a common type of variable consideration in contracts with customers. Example 20 accompanying IFRS 15 illustrates variable consideration using a construction contract penalty example. In that example, an entity enters into a contract with a customer to build an asset and the terms of the contract include a penalty if construction is not completed within three months of a date specified in the contract. In that example, the entity concludes that the penalty represents variable consideration.

Compensation for delays or cancellations is not compensation for harm or damage as described in paragraph B33

26. Paragraph B33 refers to ‘a law that requires an entity to pay compensation if its products cause harm or damage...for example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose’. In that case, the entity accounts for the obligation applying IAS 37, separately from the performance obligation in the contract with the customer. The Board explains in paragraph BC378 that the performance obligation in such a contract ‘is to transfer the product to the customer...any obligation of the entity to pay compensation for the damage or harm that its product causes is separate from the performance obligation’.
27. Those who support the alternative view say paragraph B33 applies to the transfer of services as well as goods. The compensation for flight delays and cancellations is stipulated by ‘law’ and the law refers to ‘compensation’—if a flight is delayed or cancelled, the compensation reimburses the customer for damages. For these reasons, they see no reason not to conclude that paragraph B33 applies to compensation for delayed or cancelled flights.
28. We disagree. Although an entity could provide compensation for harm or damage caused by products in transferring a service to the customer, we think this is not the case in the submission.

29. To explain, consider a contract for the transfer of a painting service to a customer. Legislation stipulates the customer's right to compensation if the entity were to inadvertently use paint that could cause harm to the customer's health, for example lead-based paint. In that fact pattern, any compensation would be for harm or damage caused by the paint—therefore, applying paragraph B33 any compensation that the entity might be required to pay is separate from the consideration to which it is entitled in exchange for transferring the promised painting service.
30. In contrast, if a flight is delayed or cancelled the entity fails to transfer the promised flight service to the customer. Instead, if the flight is delayed the entity has transferred a different service (see further discussion in paragraphs 31–32 below). Consequently, any compensation for a delayed or cancelled flight relates directly to the entity's performance obligation to transfer a flight service; it is not separate from it.

Compensation for delays or cancellations is part of the transaction price

31. In our view, compensation for flight delays or cancellations is part of the transaction price and creates variable consideration in the contract. The compensation relates directly to the entity's performance under the contract—the promise to transport the customer from one specified location to another by a specified time on a particular date. The compensation is payable when the entity has failed to perform under the contract. In that situation, the service transferred to the customer (for example, transporting a customer from London to Singapore at 19.00 on 24 May) is different from the service promised in the contract (for example, transporting the customer from London to Singapore by 08.00 on 24 May). It follows that the consideration to which the entity is entitled in exchange for transferring the flight service to the customer at, for example, 19.00 on 24 May is different from the consideration to which it would have been entitled in exchange for transferring the promised flight service in the contract (by, for example, 08.00 on 24 May).
32. We think treating compensation for a delayed or cancelled flight as variable consideration and, thus, as part of the transaction price aligns with the core principle of IFRS 15, ie 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. As noted above, a delayed flight (on which

compensation is payable) means that the entity transfers a flight service that is different from the flight service promised in the contract. Accordingly, the consideration to which the entity is entitled in exchange for such a flight may be different from the consideration to which it would be entitled if the flight were not delayed.

Compensation for delayed, lost or damaged baggage

33. The submitter notes that a similar question arises regarding compensation for delayed, lost or damaged baggage. In some jurisdictions, legislation stipulates a customer's right to compensation if the customer's baggage is delayed, lost or damaged during a flight.
34. In our view, such compensation is also part of the transaction price and creates variable consideration in the contract for the same reasons as described in paragraphs 22–32 of this paper. If the customer is entitled to such compensation, then we think the entity's performance obligation is to transport the customer, and its baggage (undamaged), from one specified location to another by a specified time on a particular date. Consequently, any compensation for delayed, lost or damaged baggage relates directly to the entity's performance obligation and is not separate from it.

Question 1 for the Committee

Does the Committee agree with our analysis of the requirements in IFRS 15 set out in paragraphs 15–32 of this paper?

Should the Committee add this matter to its standard-setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?¹

35. Based on our analysis, we think the requirements in IFRS 15 provide an adequate basis for an entity to determine its accounting for an obligation to compensate customers for delays and cancellations.

Staff recommendation

36. Based on our assessment of the Committee’s agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 35 of this paper), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that outlines how an entity accounts for its obligation to compensate customers for delays and cancellations.
37. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee

2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

¹ Paragraph 5.16(b) of the *Due Process Handbook*

Appendix A—proposed wording of the tentative agenda decision

Compensation for delays or cancellations (IFRS 15 *Revenue from Contracts with Customers*)

The Committee received a request about an airline’s obligation to compensate customers for delayed or cancelled flights. In the fact pattern described in the request:

- a) legislation gives a flight passenger (customer) the right to be compensated by the flight provider (entity) for delays and cancellations subject to specified conditions in the legislation. The legislation stipulates the amount of compensation, which is unrelated to the amount the customer pays for a flight.
- b) the legislation creates enforceable rights and obligations, and forms part of the terms of a contract between the entity and a customer.
- c) applying IFRS 15 to a contract with a customer, the entity identifies as a performance obligation its promise to transfer a flight service to the customer.

The request asked whether the entity accounts for its obligation to compensate customers (a) as variable consideration applying paragraphs 50–65 of IFRS 15, or (b) applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, separately from its performance obligation to transfer a flight service to the customer.

Paragraph 47 of IFRS 15 requires an entity to ‘consider the terms of the contract and its customary business practices in determining the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer...The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.’ Paragraph 51 of IFRS 15 lists examples of common types of variable consideration—‘discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items’.

Paragraph B33 of IFRS 15 specifies requirements for an entity’s obligation to pay compensation to a customer if its products cause harm or damage. An entity accounts for such an obligation applying IAS 37, separately from its performance obligation in the contract with the customer.

The Committee observed that, in the fact pattern described in the request, the entity promises to transport the customer from one specified location to another within a specified time period after the scheduled flight time. If the entity fails to do so, the customer is entitled to compensation. Accordingly, any compensation for delays or cancellations relates directly to the entity's performance obligation; it does not represent compensation for harm or damage caused by the entity's products as described in paragraph B33. The fact that legislation stipulates the compensation payable rather than the contract does not affect the entity's determination of the transaction price—the compensation gives rise to variable consideration in the same way that penalties for delayed transfer of construction services gives rise to variable consideration when embedded in a contract for construction services.

Consequently, the Committee concluded that compensation for delays or cancellations as described in the request is variable consideration in the contract. Accordingly, the entity applies the requirements in paragraphs 50–65 of IFRS 15 in accounting for its obligation to compensate customers for delays or cancellations.

The Committee concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine its accounting for obligations to compensate customers for delays or cancellations. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—submission

B1. We have reproduced the submission below. We have not anonymised this submission because it is available of the public website of the European Securities and Markets Authority (ESMA).

As a result of work carried out by national competent authorities and ESMA's coordination activities regarding supervision and enforcement of financial information prepared in accordance with IFRS, ESMA has identified diversity in the application of the requirements of IFRS 15 *Revenue from Contracts with Customers* in relation to accounting for lump-sum payments required by legislation and made to passengers for delays, cancellations or denied boarding in the airline industry. ESMA notes that while this issue is prevalent in the airline industry, similar issues arise in other industries in relation to some non-contractual penalties. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements.

DETAILED DESCRIPTION OF THE ISSUE

Legislation exists in various jurisdictions that provides for payments to an air passenger in the event that a flight is delayed or cancelled due to circumstances that are deemed to be within the control of the airline.

For example, in the EU, the 'Flight Compensation Regulation' gives air passengers the right to be paid lump-sum compensation for delays, cancellations and denied boarding subject to specific conditions enumerated in the Regulation. The Regulation states that passengers must be compensated for a flight cancellation or a significant delay except in the case of 'extraordinary circumstances which could not have been avoided even if all reasonable measures had been taken'. The Regulation stipulates the amount of the compensation, which is disconnected from the amount paid for the ticket by the customer.

As the contract with the passenger includes by reference or implication the 'Flight Compensation Regulation', the legislation is not considered as a contract modification. The contractual promise made by the airline is to transport the passenger from one point to another on a best effort basis. Additionally, the airline promises to compensate the passenger for avoidable delays, cancellations or denied boarding in accordance with the contractual conditions and the applicable legislation. As a result, the contract is not modified even when

the passenger is compensated for the delay, cancellation or denied boarding. The airline is fulfilling the obligation from the existing contract.

As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of the abovementioned requirements of IFRS 15. ESMA understands that similar compensation payments are required also in other jurisdictions (either based on law, international convention or contract). ESMA also notes that lump-sum payments that have similar economic substance might exist in other industries. ESMA notes that refunds of the ticket price or price modifications which can also be associated with cancellation and/or denied boarding are outside the scope of this submission as no diversity has been observed in respect to their accounting treatment.

ESMA notes that IFRS 15 does not provide explicit guidance with regard to lump-sum compensation paid to the customer in case of delays, cancellations or denied boarding (whether or not based on contract or based on regulation). As a result, ESMA has observed that the following accounting policies have been developed on the basis of the accounting requirements of IFRS 15:

- a. reduction in the consideration received for the service provided, i.e. reduction of revenue (view 1); and
- b. compensation for harm caused to the passenger due to the loss of time or for costs incurred, that can be considered as a warranty payment that is recognised as a separate expense (view 2).

View 1: Reduction of revenue

Paragraph 70 of IFRS 15 states that the ‘consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity’s goods or services from the customer).’ It also clarifies that ‘an entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 26–30 of IFRS 15) that the customer transfers to the entity.’

Paragraph 72 of IFRS 15 further defines criteria when such reduction of revenue should be accounted for. According to this guidance, ‘an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

- a. the entity recognises revenue for the transfer of the related goods or services to the customer; and
- b. the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity’s customary business practices.’

Proponents of view 1 suggest that as no good or service is transferred by the customer in exchange for compensation provided for delays or cancellations, paragraph 70 of IFRS 15 applies.

In addition, proponents of view 1 note that paragraph 51 of IFRS 15 states that ‘an amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items’. Accordingly, these lump-sum payments required by the legislation could be characterised as penalties, and therefore analogous to those found in construction and service contracts for performance or delivery delays.

Finally, some proponents of view 1 limit the deduction from the revenue to the amount of the original consideration received. If the lump-sum compensation payment to the customer required by the legislation is higher than the amount of the consideration received from the customer, the reduction of revenue could be limited to the consideration received. A specific accounting policy could be developed for any compensation payment exceeding the consideration received, either as reduction of revenue or separate expense.

View 2: Presentation as separate component of expenses

On the other hand, proponents of view 2 consider that the substance of the lump-sum payment required by legislation is more akin to a warranty. Paragraph B33 of IFRS 15 provides specific guidance related to warranties by stating that when a ‘law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a

performance obligation’, an entity ‘shall account for such obligations in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets’.

Proponents of view 2 consider that the term ‘law’ as referred to in paragraph B33 of IFRS 15 includes laws, rules or regulations issued by a government or international body, or similar entity.

Proponents of view 2 highlight that though the specific guidance in IFRS 15 was drafted to be applied to physical products, it applies to services as well while needing to reflect specific characteristics of services. This analysis is confirmed by paragraph BC368 of IFRS 15, which states that the term ‘product’ should be understood as a good or as a service.

Proponents of view 2 consider this approach is further corroborated by paragraph BC378 of IFRS 15 in which the Board clarified that product liability laws do not give rise to performance obligations. That paragraph further states that ‘those laws typically require an entity to pay compensation if one of its products causes harm or damage. The boards noted that an entity should not recognise a performance obligation arising from those laws because the performance obligation in a contract is to transfer the product to the customer. To the extent that an entity expects the product(s) to be defective, the entity should recognise a liability for the expected costs to repair or replace the product. Any obligation for the entity to pay compensation for the damage or harm that its product causes is separate from the performance obligation. The Board noted that an entity should account for this obligation separately from the contract with the customer and in accordance with the requirements for loss contingencies in IAS 37 [...]’.

As the purpose of compensation payments made to customers is to compensate passengers’ costs (losses) or inconvenience (e.g. loss of opportunity or time) incurred as a result of the delay or cancellation proponents of view 2 are of the opinion that these payments could be treated as a warranty and accounted for as a cost in accordance with IAS 37. Accordingly proponents of view 2 argue that the payments required by legislation are similar to compensation for damages.

Proponents of view 2 also point out that in a large number of cases, the price of the ticket is lower than the compensation paid based on the legislation. In their view, such absence of a connection between the consideration originally paid by the customer and the compensation

paid to the customer precludes its treatment as variable consideration (view 1) as the compensation paid is not a variation in the price of the ticket but rather compensation for costs or losses incurred by the passenger. In their view, the economic nature of the compensation required by legislation is akin to a warranty or assurance payment.

Request

ESMA seeks clarification on how to account for lump-sum payments for delays, cancellations and denied boarding in the airline industry. ESMA notes that, while less material, airlines face the same issue with regard to lump-sum compensation for delayed, lost or damaged baggage and similar issues can arise in other industries with regard to lump-sum payments that are not explicitly considered as contractual penalties.

ESMA observes that different views have been expressed regarding whether, and if so to which extent, these payments can be presented as deduction from revenue or as a separate component of costs.

ESMA is of the view that the lack of clarity of the text of IFRS 15 leads to divergent practices, including within the European jurisdictions. In particular, ESMA is concerned that different outcomes can emerge depending on whether the obligation stems from a contract or from the law or regulation (even though it has the same economic substance). ESMA has already observed different views expressed and applied in the market. ESMA considers that as these different treatments impact the revenue line, which is used in a number of key performance metrics and can have impact on users' investment decisions, it can be considered material in a number of cases. Consequently, ESMA suggests that the IFRS IC clarifies the respective requirements.