

**Sue Lloyd
Chair of the IFRS IC
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom**

Agenda Item Request: Presentation of lump-sum compensation payments in the airline industry (IFRS 15)

Dear Mrs. Lloyd,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that enhances the protection of investors and promotes stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of ESMA's supervisory convergence work in the area of financial reporting, I would like to raise with you the following issue related to the application of IFRS 15 *Revenue from Contracts with Customers*.

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 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. A detailed description of the case from the airline industry perspective is set out in the appendix to this letter.

In case you have any questions or comments regarding this letter, I suggest you contact Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. 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.
2. For example, in the EU, the 'Flight Compensation Regulation'¹ 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.
3. 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, cancellation² or denied boarding. The airline is fulfilling the obligation from the existing contract.
4. 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.
5. 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).

¹ Regulation (EC) No 261/2004 of the European Parliament and of the Council of 11 February 2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights

² ESMA notes that different types of cancellations might arise possibly affecting the applicable accounting treatments. However ESMA notes that pure cancellation are relatively less common in practice and most of the cancellations result in rebooking (delay) in the originally planned journey.

View 1: Reduction of revenue

6. 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.'*
7. 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.'*
8. 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.
9. 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.
10. 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

11. 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'*.

12. 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.
13. 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.
14. 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 [...]*.
15. 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.
16. 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

17. 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.

18. 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.
19. 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.