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American Institute of Certified Public Accountants. Task Force on Airlines

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EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR FREQUENT TRAVEL AWARD PROGRAMS

(Proposed Amendment to
AICPA Industry Audit Guide *Audits of Airlines*)

AUGUST 31, 1988

Prepared by the Task Force on Airlines,
Federal Government Relations Division,
American Institute of Certified Public Accountants

Comments should be received by December 30, 1988, and addressed to
Robert E. Moran, Technical Manager, Federal Government Relations Division, File H-2-702
AICPA, 1455 Pennsylvania Avenue N.W., Washington, D.C. 20004-1007

G00255

SUMMARY

This proposed statement of position (SOP) provides guidance on applying generally accepted accounting principles in accounting for frequent travel award programs. Briefly, the proposed SOP recommends the following:

1. An amount based on an allocated revenue value of the free travel awards should be deferred as mileage is accumulated.

2. The amounts deferred should be recognized as revenue when free travel awards are used.

3. An adjustment should be made to reflect the cumulative effect of the change in accounting principle when the SOP is first applied.

The provisions of this statement would be effective January 1, 1990.

AICPA

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August 31, 1988

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), Accounting for Frequent Travel Award Programs. A summary of the proposed SOP also accompanies this letter.

The purpose of the exposure draft is to solicit comments from representatives of airlines, users of airlines' financial statements, and other interested parties. The proposed SOP is an amendment to the AICPA Industry Audit Guide Audits of Airlines.

Comments or suggestions on any aspect of this exposure draft will be appreciated. Respondents are specifically requested to provide comments on (1) the use of the deferred revenue method rather than the incremental cost method in accounting for free travel awards, (2) the deferral of revenue as mileage is accumulated rather than when award levels are reached, (3) whether the cash received by the airline from the sale (or exchange) of mileage should be accounted for in the same manner as mileage flown, (4) recognizing the change to the required accounting by a cumulative adjustment rather than prospectively, and (5) the appropriateness of the January 1, 1990, effective date.

It will be helpful if the responses refer to the specific paragraph numbers and include reasons for any suggestions or comments.

Comments on this exposure draft should be sent to Robert E. Moran, Technical Manager, Federal Government Relations Division, File H-2-702, American Institute of Certified Public Accountants, 1455 Pennsylvania Avenue, NW, Washington, DC 20004-1007, in time to be received by December 30, 1988.

Written comments on this exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA's offices for one year after January 31, 1989.

Yours truly,

Walter Schuetze
Chairman
Accounting Standards
Executive Committee

Thomas E. Sinton
Chairman
Task Force on Airlines

ACCOUNTING FOR FREQUENT TRAVEL AWARD PROGRAMS

INTRODUCTION

1. Deregulation of the airline industry has required extensive marketing efforts by airlines to meet increasing competition. The major airlines have operated with annual average load factors of 55 percent to 65 percent, with a minimal number of flights operating at a load factor of 100 percent. Since deregulation, the airlines have developed many programs and discounted fares to encourage people--the nondiscretionary as well as the discretionary traveler--to fly. These programs and fares have been designed to put certain passengers in seats at the highest possible prices and to attract, using lower prices, additional passengers to fill otherwise empty seats. The fares collected from such additional passengers are often at a significant discount from the fares paid by other passengers on the same flight.

2. For example, airlines offer companion travel ("buy one, get one free") and special promotional fares that have been heavily discounted at specific times of the year, that have specific usage or other restrictions, or both. The airlines also introduced frequent travel award programs, the so-called "frequent flyer programs," designed to develop passenger loyalty by offering awards to travelers for their continuing patronage of the individual airline. As these programs have developed, membership and the significance of the programs to the airlines have increased.

3. In general, awards granted under frequent flyer programs are earned by program members when they fly a specified number of miles or flights with the sponsoring airlines.[1] Airlines other than the sponsoring airline, travel-related businesses such as car rental companies and hotels, and businesses not related to travel participate in these programs by generating miles earned, offering awards, or both. The programs exchange discounted and free air travel or other awards for mileage accumulated by program members.

4. Various types of awards are identified by each airline and made available to participating frequent flyers who have accumulated specific levels of mileage. The higher the level of mileage accumulated, the more attractive the award. In exchange for miles accumulated up to specific levels, a program member generally earns one of the following:

- The right to buy a ticket at a discount
- The right (normally awarded on a space-available basis) to upgrade a ticket to a higher class of service after purchasing a ticket for a lower class of service
- The right to receive a free companion ticket on the same flight when the program member purchases a ticket on that flight

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[1] Hereinafter the term <u>miles</u> or <u>mileage</u> will be used to denote the accumulation of flights as well as of mileage.

- The right to receive free travel either on the sponsoring airline or on a participating airline

- The right to other nontravel awards offered from time to time

5. The airline industry's revenue cycle is unique. When a ticket is sold, the selling airline records a cash receipt or account receivable and an unearned transportation liability. The unearned transportation liability is the value of unused transportation sold by the airline. When transportation is provided, revenue is recognized and the unearned transportation liability account is reduced. The unearned transportation liability account is also reduced by billings from other airlines and refunds. A more detailed description of the revenue cycle is provided in chapter 3 of the 1981 AICPA Industry Audit Guide Audits of Airlines.

6. Awards such as discounted fares, upgrades, and free companion tickets represent sales of transportation at a future date to program members at reduced rates--that is, they are discounted transportation. As with other ticket sales, the amounts received in connection with these awards should be recorded in the unearned transportation liability account when the discounted transportation is sold and recognized as revenue when the transportation is provided.

7. Free travel awards differ from discount awards in that the airlines receive no proceeds when tickets are issued for free travel awards. The remainder of this document addresses only the accounting for free travel awards.

PRESENT REPORTING PRACTICE

8. The industry identifies an amount based on incremental cost associated with transporting a passenger in an otherwise empty seat and deducts this amount from current revenue in connection with free ticket awards. This amount is recorded in the unearned transportation liability account when program members reach the level of mileage required for free travel awards. These accrued amounts are subsequently recognized as revenue when the free transportation is provided. The use of incremental cost is based on the concept that the earnings process is virtually complete, and the amount accrued represents the cost of completion.

9. In considering the amount of incremental cost to be allocated to free travel awards, the following factors have been used:

- The number of miles that will be redeemed for awards

- The number of awards that will be used

- The number of awards that will be used for flights on participating airlines rather than on the sponsoring airline, which may reduce the effect on the sponsoring carrier

- The number of miles that will be redeemed for items other than air transportation o Route segments and class of service on which awards are expected to be used[2]

RECENT AND PROSPECTIVE DEVELOPMENTS

10. Since the introduction of frequent flyer programs, the airlines have increased their marketing emphasis on these programs and have recently enhanced program benefits to members. Additionally, sponsoring airlines may also receive cash in exchange for mileage and other services provided to participating vendors and other third parties. Sponsoring airlines have also offered to sell mileage to program members to permit them to reach free travel and other award levels more quickly. Frequent travelers are now able to accumulate mileage much more quickly than originally, without necessarily increasing the frequency of their air travel. Consequently, many of these free travel awards are no longer a premium that requires extensive travel but have become another form of discounted transportation. To be consistent with the accounting for discounted tickets, each free ticket awarded would have a revenue value, rather than an incremental cost value, assigned to it.

11. Recent and perhaps future modifications to these programs may put new pressures on the airlines to permit displacement of revenue passengers to fulfill the airlines' obligations to holders of free travel awards.

CONCLUSIONS

12. The Accounting Standards Executive Committee (AcSEC) believes that an amount based on the allocated revenue value of a free travel award to the airline should be deferred in the unearned transportation liability account. Such deferral should occur as mileage is accumulated, rather than when free award levels are reached as presently practiced by the airlines.

13. Such deferred amounts represent the discounted fares (allocated revenue values) to be recognized as revenue when the awards are used. Determining the allocated values to be deferred is complex and will require the estimates discussed in paragraph 10 as well as additional significant estimates. One of the principal factors in this revenue allocation estimate will be the yield rate (revenue per mile) assigned to the transportation associated with the awards.

14. The allocated revenue values assigned to free travel awards should be similar to other discounted fares collected for tickets that have similar restrictions and that are sold on routes where free travel awards are expected to be utilized. These restrictions may include capacity controls, nontransferability to another party, and the requirement to use the free travel on a sponsoring airline or another airline participating in the program.

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[2] Free travel awards generally entitle the holder to travel on a variety of routes within the sponsoring airline's system or on another airline participating in the program.

15. An airline may offer program members awards that are in the form of discount tickets because they require payments by members, but the payments are nominal. For example, the discounts are so large that the revenue amount to be collected is less than the allocated revenue values applicable to free travel awards. Such awards should be accounted for as free travel awards.

EFFECTIVE DATE AND TRANSITION

16. In view of the practical limitations and cost-benefit considerations, AcSEC has established an effective date of January 1, 1990, for the implementation of the conclusions of this proposed SOP.

17. A majority of AcSEC believes that in the year this proposed SOP would first be applied, an adjustment should be made to reflect the cumulative effect of changes in accounting principles in accordance with paragraphs 17 through 26 of Accounting Principles Board Opinion 20.

18. A minority of AcSEC believes that the revenue concept should be applied prospectively to mileage accumulated after January 1, 1990.

19. This effective date will allow airlines sufficient time to design and implement the necessary databases and systems (or to modify existing systems) for accumulating and processing the data and integrating such systems, to the extent necessary, into existing reservations and revenue accounting systems.

20. Until the conclusions of this proposed SOP are adopted, airlines may continue to apply the incremental cost method when award levels are reached. Because recent and prospective modifications to these programs have created and are likely to continue to create increased pressure on airlines to permit displacement of revenue passengers, and because the airlines are now selling mileage directly to program members or receiving cash in exchange for mileage and other services rendered to participating vendors and other third parties, AcSEC believes that (a) the accrual of incremental cost should be supplemented, where appropriate, by the accrual of an additional amount that reflects the loss of revenue because of the displacement of revenue passengers and (b) cash received in exchange for mileage from program members and participating vendors or third parties should be deferred and recognized as revenue when the transportation is provided.