ACCOUNTING FOR AIRLINE FREQUENT FLYER PROGRAM LIABILITIES: DEFERRED REVENUE VS. INCREMENTAL COST

Brian J. Franklin, College of Business and Public Policy, University of Alaska Anchorage, 3211 Providence Drive, Anchorage, AK 99508, 907-268-4233 Ext. 401, bfranklin@frontiertutoring.com
C. Patrick Fort, College of Business and Public Policy, University of Alaska Anchorage, 3211 Providence Drive, Anchorage, AK 99508, 907-786-4138, cpfort@alaska.edu
Kevin E. Dow, College of Business and Public Policy, University of Alaska Anchorage, 3211 Providence Drive, Anchorage, AK 99508, 907-786-4146, kdow@alaska.edu

ABSTRACT

The obligation to provide free or reduced-fare travel through passengers' accrued frequent flyer program (FFP) benefits represents a significant liability on every major U.S. airline's balance sheet. Major U.S. airlines employ one of two methods to account for their FFP liabilities. The Deferred Revenue Method recognizes a liability for the fair value of the outstanding miles (with *fair value* defined under International Financial Reporting Standards (IFRS) as the amount for which the award credits could be sold separately). The Incremental Cost Method recognizes a liability for the marginal cost of providing air transportation to eligible passengers (i.e. the cost of taxes, fuel, food, etc. to fly one additional passenger on a seat that otherwise would have gone empty—generally a nominal amount).

Incremental cost accounting for FFPs has been subject to increasing scrutiny over time. In the last several years airlines have reduced capacity due to high fuel prices and weak demand during the global economic recession, which has caused flights to be fuller and has increased the chance that, for any given seat, a passenger flying on redeemed FFP miles could displace a fare-paying passenger. The incremental cost method does not account for that opportunity cost.

The Financial Accounting Standards Board (FASB) considered, but never reached authoritative guidance on, how to account for airline frequent flyer programs. In contrast, airlines reporting under IFRS have been required to use the deferred revenue (fair value) method of accounting since July 2008. Reporting FFP liabilities under fair value, however, has resulted in some airlines' frequent flyer liabilities increasing dramatically. For example, Delta Air Lines' frequent flyer liability increased from $412 million to $2.4 billion when it was revalued under fair value following Delta's Chapter 11 bankruptcy and subsequent fresh-start accounting. As a result, FFP liability accounting has become the subject of controversy between accounting standard-setters and the airline industry.

The goal of this thesis project is to examine and answer the following central question: In the context of investors' informational needs, what are the circumstances under which the deferred revenue method is preferable to the incremental cost method of accounting for FFP liabilities?

PROJECT DESIGN & ANTICIPATED RESULTS

The project involves collecting relatively accessible data and performing qualitative and limited quantitative analysis. Specifically, the project will:

1. Define investors' informational needs. Possible sources include the FASB Conceptual Framework, among others.
2. Examine the extent to which each accounting method meets the aforementioned needs.
3. Evaluate other arguments for and against each method, including viewpoints and incentives of various stakeholders other than investors (e.g., airline managements).
4. Conclude on the central question.

The project in its final form will present an introductory analysis of the two methods U.S. airlines use to account for their frequent flyer programs, as well as the associated advantages and disadvantages when considering investors' informational needs.