KYROS

# EIGHT IMPERATIVES for LOYALTY PROGRAM FINANCIAL REPORTING

# About KYROS Insights

KYROS provides sophisticated predictive analytics solutions that help companies maximize the economic performance of their loyalty programs.

The proprietary KYROS Dashboard allows organizations to easily assess cost-benefit tradeoffs and align business leaders around decisions that focus on value maximization rather than cost minimization.

Our goal: to empower departments across your organization — from marketing to finance and accounting — to make better, faster decisions that drive long-term customer loyalty and grow your bottom line.

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# Introduction

End of quarter means a lot of things for many people. For accountants it means crunch-time.

This signifies the scramble to get the quarterly report accurate. High expectations and changes in reporting needs can make these stressful times of year.

With the changes in loyalty program revenue recognition standards, this process has come under fresh scrutiny. Loyalty program accountants must now incorporate the new reporting standards ASC 606 and IFRS 15, while still optimizing their financial statements for profitability.

Getting the financial reporting right is absolutely essential, yet difficult. Without predictive modeling and a solid plan it can be next to impossible.

Rather than get lost in the details (as it's all too easy to do), we've compiled eight imperatives for loyalty program financial reporting. As you enter the end of each quarter, we hope this will streamline your processes and bring better financial insight to your loyalty program.

Imperative 1

# Validate Your Data

# Accuracy is everything in accounting.

Naturally, the first step is to ensure your records are accurate and correct. Good data is essential.

Each accounting period should be checked to ensure that individual transactional data matches with the total outstanding point balance used in the liability calculation. Underlying data for breakage estimates must match with data used for the books.

In general, prior period trends should also be consistent. Examine the number of points earned, points redeemed, and points expired each month. Month-to-month point volumes should appear similar when compared to historical years, notwithstanding some exceptions.

A few exceptions to watch out for include:

- Flash promotions increasing redemptions
- Temporary grace periods decreasing point expiration
- New expiration rule increasing point expiration

## To be safe, hedge your exposure.

**A non-essential but prudent caution is to consider your foreign exchange exposure. If your liability is significantly exposed to foreign exchange risk, your modeling and liability estimate becomes much more complicated.**

**An effective currency risk management strategy involving forward contracts can minimize and hedge your exposure to foreign exchange fluctuation risks.**

Imperative 2

# Create a System to Allocate Redemptions to Points Earned


# Accurate breakage estimates require correctly allocating redemptions to **actual point earnings.**

Loyalty program point allocation has similarities to inventory valuation — as customers use their points, redemption costs should be allocated to specific point earnings. Much like when physical inventory is sold, revenue and costs of goods sold is applied for each unit sold.

**The industry standard for most loyalty program models is First In First Out (FIFO). Under FIFO, point redemptions are tied to the member's earliest earned points (first in) that remain outstanding.**

Unlike inventory valuation, there is no required method for point allocation. Some programs might find using FIFO isn't realistic or advantageous:

- Programs with expiration rules varying by point
- Programs whose members choose which points to redeem

Regardless of which method you follow, a clean system will tie redemptions to specific point earnings.

Imperative 3

# Update Breakage and Fair Value Estimates

# Breakage lies front and center for loyalty program accounting.

Your program is optimized for customer engagement and increasing revenue, and breakage is the variable that balances these two goals.

Breakage is a key assumption underlying the financial strategy for a loyalty program model. **With the new standards, it's more important than ever to land on an accurate estimate.**

Before we dive into the importance of breakage, here's a helpful list of key terminology to keep in mind:

## Updating Breakage Estimates

**Breakage** is the percentage of outstanding points that will ultimately go unredeemed. This estimate is used to calculate loyalty program liability.

**Breakage =** % of points that go unredeemed

**Loyalty Program Deferred Revenue =** Outstanding points x (1 – Breakage) x FVPP

**Fair Value Per Point (FVPP) =** Expected fair value to the customer of each point that will be redeemed

**Revenue Recognition Rate =** Deferred revenue / future points expected to be redeemed

# Breakage estimates are updated with each new period, as new customer data rolls in. For example:

**Last Period:**

Deferred Revenue Balance = **$900**

Points Ultimately Expected to be Redeemed = **1,200**

Revenue Recognition Rate = $900 / 1,200 points = **$0.75**

Points Redeemed in Period = **200**

Revenue Recognized in Period = 200 x $0.75 = **$150**

**Next Period:**

New Deferred Revenue Balance = $900 - $150 = **$750**

Remaining Points Expected to be Redeemed Based on Prior Breakage Estimate = 1,200 - 200 = **1,000**

Remaining Points Expected to be Redeemed Based on Updated Breakage Estimate = **950**

Updated Revenue Recognition Rate = $750 / 950 points = **$0.79**

Because we now expect fewer points to be redeemed (higher breakage), the revenue recognized with each future point redeemed increases.

## The Dangers of Inaccurate Breakage Estimates

In an ideal world, your breakage estimate is spot on. As members redeem their points, deferred revenue is recognized and your accounts balance out.

In reality, estimates require continual adjustment. However, if you significantly over or underestimate breakage, significant revisions will be required:

- **Breakage estimate too high** and your deferred revenue will be too low, requiring a one-time (potentially) material increase in program liability;

- **Breakage estimate too low** and your deferred revenue will be too high, resulting in stuck revenue that will never be recognized.

## Accurate breakage estimates require predictive actuarial models

The consequences of inaccurate breakage estimates can be avoided with robust actuarial modeling. Actuaries excel at estimating program liabilities from uncertain cash flows and consumer behavior.

However, traditional actuarial science methods, such as those used in insurance, are not ideal for loyalty program applications; the loyalty program industry is far more dynamic and fluid than the insurance industry. Quarter to quarter, loyalty program member behavior can change as customers become more engaged or program rules are tweaked. The insurance industry has historically experienced more consistency, with trends that are slower to develop.

Predictive modeling is the best solution for estimating accurate breakage rates. These advanced actuarial models can calculate breakage estimates down to the individual member level.

## Fair Value Per Point Estimates

Fair value per point (FVPP) is a component of calculating deferred revenue for a loyalty program. FVPP is a dynamic measure that can change with each period.

**A number of variables can change FVPP:**

- Changes in utilization distribution
- Changes in award charts
- Temporary promotional rewards
- Changes in foreign exchange rates
- Inflation
- Seasonality in standalone value of rewards (e.g., flights, hotel nights)

## Assess actual member behavior versus forecasts

Estimates are only worthwhile when they are accurate. Each period, compare actual results to your forecasted values for breakage, FVPP, and redemption patterns. Ask yourself questions such as:

- *How did the volume of points redeemed compare to our model predictions?*
- *Did members redeem their points on the award types our model predicted?*

If your answers aren't quite what you'd hoped, you'll need to assess and adjust.

In analyzing your model performance, you'll be able to identify what's driving changes in your estimates. This is essential to communicate a clear story to your CFO and auditors. **A member-level model is particularly useful for constructing a clear narrative.**

Imperative 4

# Record accounting entries for reporting periods

# Each financial reporting period will require updating key loyalty program accounts.

The following items will change and require the corresponding accounting activity:

- Points earned
- Points redeemed
- Points expired
- Updated breakage estimates

## Points Earned

Any new points earned will require an associated entry to deferred revenue. The value should be based on the relative standalone selling value of the points.

The amount of deferred revenue should incorporate your latest breakage estimate.

For example, if breakage = 10%, each redeemable dollar should result in deferring 90 cents.

## Points Redeemed

Points redeemed during the reporting period will result in recognizing revenue and reducing deferred revenue liability.

The revenue recognition rate represents the proportion of deferred revenue realized per every redeemable point.

### Let's take a closer look:

**Beginning of the Period:**
Deferred Revenue Balance = $900
Points Ultimately Expected to be Redeemed = 1,200

**Revenue Recognition Rate** = $900 / 1,200 points = 0.75

**During the Period:**
Points Redeemed =200
Deferred Revenue Recognized = 200 x 0.75 =$150

## Points expired

Points expired during the period require no adjustment, as long as the deferred revenue account incorporates point expiration estimates.

## Final adjustments

This list is by no means exhaustive. A few noteworthy additional items to adjust include:

- Adjust deferred revenue balances with latest foreign exchange rates
- Adjust revenue recognition rate for changes in breakage estimates

Member-level predictive analytics models help quantify the magnitude of exchange rate risk by aggregating results up to a total currency level.

Imperative 5

# Seek an Actuarial Opinion

# Accurate liability estimates are essential for optimal program performance.

However, these estimates are difficult to calculate. Actuaries can be resourceful tools when it comes to predicting liabilities. These predictions are extremely important to the success of your business. Don't allow an inaccurate prediction to lead to disaster.

A company's CFO and auditors are required to certify the accuracy of company financial reporting statements. Given the financial statement ramifications of an inaccurate breakage estimate, actuarial opinions are sought to justify loyalty program liability.

An actuarial opinion is signed by a credentialed actuary as proof of thorough review and vetting of loyalty program liability assumptions, and provides the following:

- Support for booked breakage estimate to auditors
- Peace of mind for the CFO (booked liability is materially significant to financial statements)
- Protection against key material risk factors (inaccurate estimates of loyalty liability or breakage)

The opinion provided will usually be presented as a range of reasonable estimates, any of which are actuarially justified for booking purposes. Often, actuaries will present their analysis to the CFO and auditors verbally, in addition to a physical document.

Imperative 6

# Prepare Financial Disclosure

# There's already a long list of required disclosures for loyalty programs. After ASC 606 and IFRS 15, the list has only gotten longer.

## Required disclosures include:

- Liability change during the year
  - How has your program's liability shifted due to breakage or other factors?
- How much revenue recognized in the period is included within opening liability balance
  - Are you monitoring your Revenue Recognition Rate?
- When the company satisfies its performance obligations
  - Do you have a clear system for tracking point redemptions?
- Nature of the goods and services the company has promised to transfer
  - Are you utilizing Far Value Per Point estimates?
- Estimate of the timing to satisfy the liability
  - Satisfying liabilities can take years, do you have a good estimate of that timeline in place?
- Significant judgments
  - Did you make any significant judgments in applying the accounting rules?
- Method used to determine transaction price and allocate it to performance obligations
  - What method are you using to determine the transaction price?

A deeper dive (and examples) into the financial reporting requirements is available here.

Imperative 7

# Assess Progress Against your Financial Plan for the Year

While imperatives 2 through 6 account only for the loyalty program liability, there are additional transactions and measures to track each month. These include:

## Cash Flow Implications

- Points earned bring in revenue
- Points redeemed carry a cost

## Forecasting Implications:

- Forecast liability and cash flow
- Anticipate year-end financial position
- Determine budget availability
- Plan for the medium- to long-term horizon

Comparing actual transactions and breakage estimates to forecasts will help identify if your program is over- or under-performing. Of course, random fluctuations can be expected, but large variances should be investigated and understood.

Variances can be examined manually, but will be most effectively assessed through drilling down with member-level models.

Over time breakage will shift. As frequent customers accumulate more points, they become "power users" (i.e., customers with a larger share of the overall point distribution). It's worth noting that these power users will tend to push the overall breakage rate down.

Imperative 8

# Uncover Further Opportunities to Optimize

Finally, it's worth remembering that the financial reporting process highlights many metrics that can be optimized for better overall performance. Prediction is essential when optimizing your loyalty program's performance. Amazing amounts of revenue can be generated with the correct predictions in place. Understanding your customer's lifetime value is an important aspect of this optimization.

Customer lifetime value (CLV) represents another key opportunity. CLV is the present value of all net cash flows expected for each member. This metric can be calculated through implementing a member-level model.

CLV represents a member-specific metric to focus on when maximizing the profitability of your customer loyalty program. The goal should be to increase CLV for each member each month. This is achieved through a mix of driving customer engagement and purchases.

By implementing a CLV model, program managers can also identify and target new members with a high CLV-to-acquisition-cost ratio.

It can be tempting to focus primarily on minimizing your program liability. After all, it's the only piece of a loyalty program that shows up on your financial statements. However, long term profitability and growth depend on maximizing CLV and customer revenue net of cost.

# Conclusion

As your quarter-end nears, deadlines get tighter and deliverables become more urgent. When assessing your next reporting period, refer to these 8 reporting imperatives.

**Imperative 1:** Validate data

**Imperative 2:** Allocate redemptions to points earned

**Imperative 3:** Update breakage and fair value estimates

**Imperative 4:** Record accounting entries for reporting periods

**Imperative 5:** Seek an actuarial opinion

**Imperative 6:** Prepare financial disclosures

**Imperative 7:** Assess progress against financial plan for the year

**Imperative 8:** Uncover further opportunities to optimize

At the end of any reporting period, understanding what goes behind each of these imperatives will help you continue to improve the accuracy of your financial reporting, and provide valuable insight to your company as it looks for new ways to optimize its financial performance.

Take the next step in optimizing your loyalty program's performance.

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