KYROS

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How CFOs Can De-Risk Loyalty Program Points Liabilities & Ensure Financial Stability

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Introduction

Loyalty programs drive customer retention and brand loyalty, but they also create long-term financial obligations that companies often underestimate. Every time a point is issued, a financial liability is created—one that may not materialize for years.

This future cost, known as loyalty program liability, is often one of the largest liabilities on the balance sheet. Redemption of points is usually the largest expense in a loyalty program's business model.

Without precise liability estimation, businesses risk budget shortfalls, financial instability, and audit scrutiny. Yet, many companies rely on spreadsheet models that oversimplify redemption behavior, leading to inaccurate financial projections.

This guide will break down:

- What loyalty program liability is and why it matters
- The risks of inaccurate estimates and how they impact financial planning
- Best practices for mitigating risk and ensuring financial stability

What is Loyalty Program Liability?

Loyalty program liability is a provision on your balance sheet that reflects the expected cost of loyalty points issued today that will be redeemed in the future. Since these redemptions result in real financial obligations, liability management is critical to the financial health of a loyalty program.

Liability = [Outstanding Points] × [URR] × [CPP]

Where:

<u>Outstanding Points</u> = The total number of loyalty points issued but not yet redeemed.
<u>Ultimate Redemption Rate (URR)</u> = The percentage of points expected to be redeemed.
<u>Cost Per Point (CPP)</u> = The expected cost incurred for each redeemed point.

Accounting rules make liability estimation more complex than this formula suggests—but for this guide, this simplified version provides a foundational understanding.

Why this matters:

- The redemption of points is often the single largest expense in the loyalty program business model.
- Liability is often the one of the largest liabilities on the balance sheet.
- Misestimating it leads to financial volatility, balance sheet instability, and audit risk.

What Happens if I Misestimate Loyalty Liability?

Loyalty program liabilities are highly leveraged, meaning small miscalculations in URR or CPP can have significant financial consequences. Here's why:

1. Leveraged Financial Volatility

Usually the outstanding point balance grows to a significant amount. At that scale, even a 1-2% change in URR, when multiplied with a huge outstanding balance, can shift liability forecasts by millions of dollars, impacting cash flow and profitability. Loyalty liabilities are sensitive to even small assumption errors.

2. Audit Risk

Loyalty liability is often classified as a Critical Accounting Estimate, meaning auditors closely scrutinize the assumptions behind it. If an auditor challenges your estimates, you may need to:

- Rebook liability reserves, causing unexpected financial swings.
- Provide extensive documentation and justification.
- Risk financial restatements—or in worst cases, audit failure.

3. FP&A Risk

Many programs assume URR is static—but URR changes over time as customer behavior shifts and the program accumulates more engaged customers. If liability forecasts don't account for these changes, year-end financials can diverge from projections, creating large variances from plan and financial instability.

4. ROI Risk

Because point costs are the denominator in ROI calculations, an incorrect liability estimate skews ROI performance reporting—leading to misguided investment decisions on loyalty program spend.

How to Reduce Leveraged Financial Volatility

To reduce liability volatility, businesses must use stable, accurate URR & CPP estimates. However, predicting liability costs is a difficult actuarial challenge because:

- Points are issued today but may not be redeemed for years.
- Redemption behavior is highly dynamic—what worked in the past may not reflect future trends.
- Loyalty programs are designed to change customer behavior—making historical data less reliable for forecasting.

The solution? Actuarial science combined with modern predictive modeling.

Why Actuarial Science is Critical

Actuaries are experts at predicting long-term financial liabilities. While traditionally used in insurance (e.g., predicting life expectancy), the same principles apply to forecasting when points will be redeemed.

Why Spreadsheet Models & Traditional Actuarial Methods Fail

Basic spreadsheet models assume static behaviors and fail to account for real-time shifts.

Traditional actuarial models (used in insurance) aren't responsive enough to the fast-changing nature of loyalty programs.

The KYROS Approach: Machine Learning + Actuarial Science

- Incorporates real-time customer data → Creates dynamic, behavior-driven URR forecasts
- Uses predictive modeling → Adjusts to changing redemption patterns in real time
- Produces more stable and accurate estimates → Eliminates reliance on outdated assumptions

How to Reduce Audit Risk

Auditors will challenge any liability estimate that lacks actuarial credibility.

To avoid last-minute audit headaches, businesses should have a clear audit package that includes:

- A professionally signed actuarial opinion from an independent actuary.
- Detailed actuarial exhibits that justify URR & CPP estimates.
- Backup documentation to support all assumptions and calculations.

Work with actuaries who specialize in loyalty programs.

Most actuaries work in insurance, not loyalty. Generic actuarial techniques fail in this space because they aren’t responsive enough to changes in redemption behavior.

KYROS' actuaries specialize in loyalty programs, ensuring estimates hold up under audit scrutiny.

How to Reduce FP&A Risk

Even with accurate URR and CPP estimates today, they will change over time as your loyalty program evolves. If your forecasts don't account for this:

- Your program may become more engagement-heavy (more redemptions, higher URR).
- Your redemption patterns may shift as customers engage differently.
- Budget variances will arise, creating instability in year-end reporting.

How to solve this:

- Use forward-looking FP&A models to track how URR & CPP are expected to change.
- Regularly update financial forecasts based on new engagement trends.
- Ensure CFOs aren't surprised by liability fluctuations at year-end.

How to Reduce ROI Risk

A loyalty program's value comes from improved retention compounding over time. But because points are the primary incentive mechanism, their cost directly impacts ROI.

The ROI Formula:

ROI = Incremental Value Created by the Loyalty Program ÷ Cost of Points Issued

If you miscalculate liability:

- You're working with inaccurate cost assumptions.
- You may over-invest in ineffective rewards.
- You may underfund high-performing incentives.

The Role of CLV in Loyalty ROI

CLV (Customer Lifetime Value) quantifies the long-term profit impact of loyalty investments.

By incorporating CLV into strategic planning, businesses can:

- Show how loyalty programs drive enterprise value beyond short-term costs.
- Justify strategic investments in program enhancements.

Using Data to Maximize ROI

- Use points as a precision incentive → Instead of broad discounts, optimize for individual customer behaviors.
- Experiment with incentive structures → Machine learning can identify which customers respond best to specific offers.
- Reduce waste & maximize effectiveness → Identify where points drive actual behavior change vs. where they don't.

What's next?

Loyalty program liability isn't just a financial metric—it's a key driver of program sustainability and profitability. Without actuarial precision, businesses risk:

1. Budget shortfalls & cash flow instability
2. Audit failures & financial restatements
3. Misallocated investments that impact loyalty program ROI

KYROS helps loyalty teams take control of their liability estimates by:

1. Combining actuarial expertise with machine learning for more accurate forecasting.
2. Providing audit-ready models that meet regulatory scrutiny.
3. Helping brands optimize liability strategies to improve financial outcomes.

Want to ensure your loyalty program liability is accurate & audit-ready?

Click here to schedule a consultation with KYROS today.