School of Management – Purdue University

<u>MGMT 602 – Fall 2009 – Assignment 1 due Tuesday, September 8, 2009.</u>

The article below appeared in Business Week, June 22, 2008, page 19.

THE BUSINESS WEEK

AIRLINES' INCOME A LA CARTE

While many U.S. airlines were in the red in the typically slow first quarter—the 10 largest carriers lost a collective $1.7 billion—the setback was far less serious than analysts forecasted, sparking a rally in airline stocks. Cheap fuel helped, but there was another reason for the better-than-expected results: incidental income streams.

The real cash cow these days is the frequent-flier programs, says Tim Winship, who helped develop such programs for Singapore Airlines and Hilton Hotels and now runs FrequentFlier.com. Winship estimates that the three largest carriers—Delta, United, and American—each generate roughly $1 billion annually from the sale of frequent-flier miles to hotels, rental-car companies, and others offering points-for-miles to their customers.

It's a revenue stream that's almost pure profit, since the marginal cost of transporting a free passenger is basically a can of soda, a bag of peanuts, and the incremental fuel cost—a little less than 3¢ a mile at current prices, or about $38 for a round trip between Chicago and New York. That's less than a tenth of the $500 to $1,000 an airline collects by selling the points needed to win one free seat. "This is a very profitable business—more profitable than the flying itself," says Winship.

Airlines are also raking in revenue from their most recently imposed fees. Jay Sorensen, president of IdeaWorks, an industry consulting firm, estimates that United will pocket $300 million in extra revenue this year from its recently added baggage fees. And Sorensen expects a proliferation of the fees some airlines charge customers who seek more legroom, given how lucrative these charges are proving for such early adopters as US Airways. That carrier, he says, will probably generate an extra $50 million a year from passengers paying to sit in an exit row. Industry experts predict airlines will roll out more à la carte fees—for everything from early boarding and fast-track security screening to the right to sit next to an empty seat. *—Dean Foust*

Required:

Critically evaluate the profitability of frequent-flyer programs and add-on fees such as added baggage fees. Identify an airline and review the financial statements of that airline and report on the accounting for and disclosure of these revenue streams and their frequent-flyer program. You should cite all sources used in preparing your response. If you wish to access the financial reporting requirements under GAAP you can access the accounting standards using the ID and password listed below.

FASB website: www.fasb.org Accounting Standards Codification. You may access the Academic Accounting Access by using: User ID: AAA51743 and

Password: spur543. Please do not disseminate this access information.

Divided United?

A short analysis on the impact of United's accounting of various add-on programs and how their impact on their financial statements. I prepared this out of academic request and not the usual corporate valuation demands, where I usually focus on companies that may make great investments. Thus, I am saying, do not read this is you are interested in my investment opinion. Read this if you are interested in airlines and my opinion on how they may potentially distort their financial statements.

Glen Bradford

MGMT 602

Financial Statement Analysis

Homework 1

Remarkably, the first thing that comes up when searching google finance is "United Airlines matches American in doubling elite flier miles" (Chicago Daily Herald - Sep 3, 2009).

For starters, I never plan on investing in an airline company. So, this is new territory for me. Second, I usually don't do research on companies I've predetermined not to be worth my time. This is a deviation from Prim's algorithm altogether; but here goes. I might as well start with what I consider to be the worst airline that I know of. United Airlines is statistically the worst airline to fly as they provide the passenger with the most likely overbooked and delayed flights out of any airline based on a couple private statistical reports that I have seen. The Ticker is UAUA. Usually, the only resources that I would use to evaluate a company would be their annual and quarterly reports as well as any current developments that they have disclosed that I can use to calculate my estimations for future expectations for top line revenues and bottom line net income and even more bottom line, dividends.

After scanning hundreds of pages of SEC filings, I knew that this would be no easy task. In the last 5 years, the company has not made $1, but somehow managed to report positive income this last quarter. I don't believe it's necessary to look back further than 5 years in order to figure out what's going on in most cases and will cut myself off there.

Note that there was no information about their frequent flier programs in their 10-Q's, but only in the 10-K's. So, the important information I'll be looking at from the 10-Ks will be tabbed over:

> The Company also generates revenue through its Mileage Plus ® Frequent Flyer Program ("Mileage Plus"), United Cargo SM and United Services. Mileage Plus contributed approximately $700 million to passenger and other revenue in 2008 and helps the Company attract and retain high-value customers. United Cargo generated $854 million in freight and mail revenue in 2008. United Services generated $167 million in revenue in 2008 by utilizing downtime of otherwise under-utilized aircraft maintenance resources through third-party maintenance services.

What does this mean? These marginal services total $1.7B and 8.5% of 2008 revenues. The frequent flyer program assists in filling planes by ideally offering what would be empty seats to reward customers that result from hotel stays, previous flying, percentages of sales on special credit cards, or more. The Cargo program packs US mail onto the cargo bays of United Airlines planes for a fee. The Services program charges other airlines for maintenance services that United Airlines performs.

> There are more than 54 million members enrolled in Mileage Plus. In 2008, 2.3 million Mileage Plus travel awards were used on United, as compared to 2.2 million in 2007.

So, roughly 5% of the members put any of their benefits to use in any given year.

> ***Accounting for Frequent Flyer Program Miles Sold to Third Parties and the Advanced Purchase of Miles.*** The Company has an agreement with its co-branded credit card partner that requires our partner to purchase miles in advance of when miles are awarded to the co-branded partner's cardholders (referred to as "pre-purchased miles"). The pre-purchased miles are deferred when received by United in our *Statements of Consolidated Financial Position* as "Advanced purchase of miles." The Company amended its agreement with its co-branded credit card partner in 2008. See Note 17, "Advanced Purchase of Miles," in *Combined Notes to Consolidated Financial Statements* for a description of this agreement and its 2008 amendment. Subsequently, when our credit card partner awards pre-purchased miles to its

cardholders, we transfer the related air transportation element for the awarded miles from "Advanced purchase of miles" to "Mileage Plus deferred revenue" at estimated fair value and record the residual marketing element as "Other operating revenue". The deferred revenue portion is then subsequently recognized as passenger revenue when transportation is provided in exchange for the miles awarded. Accounting for the Company's air transportation element and marketing elements are described below:

The Company's frequent flyer obligation was recorded at fair value at February 1, 2006, the effective date of the Company's emergence from bankruptcy.

There is also a bunch of information relating UAL's historical buildup of frequent flier miles and accounting for those miles since UAL has emerged from bankruptcy. In the past, it's apparent that they may have used this program to leverage their earnings:

The Company revalued its Mileage Plus Frequent Flyer Program ("Mileage Plus") obligations at fair value as a result of fresh-start reporting, which resulted in a $2.4 billion non-cash reorganization charge.

The Company's change in the expiration period for unused frequent flyer miles increased revenues by approximately $28 million, $47 million, $50 million and $121 million in each quarter of 2007, respectively.

Verdict: For roughly 5% of the company's revenue stream, there is very little information on current reserves or future cost implications or a mileage plus additional cost reserve on the balance sheet as a liability. So, I'm pretty sure they are registering these revenues as straight revenues with no additional liabilities associated with them. It's as if they are gift cards but the additional services provided won't cost the company any additional expenses. Scandalous? I think so. Wreckless? Probably. Am I surprised? Not really. Like I said, this is a company that hasn't made $1 in the last 5 years and is still in business.