Tiralis Global

Consulting

CARGO REVENUE ACCOUNTING

Is it keeping pace?

Eddie Eldridge, Co-founder of Tiralis Global, discusses the challenges facing cargo revenue accounting to meet the changing and more demanding needs of cargo business.

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Air Cargo Industry

IATA forecast industry-wide cargo revenue of $116.1bn for 2019, representing 13% of total estimated airline revenues. For individual network carriers, cargo typically contributes between 7% & 15% of total traffic revenue and it represents between 15% and 25% for a small group of carriers. Based on IATA figures, the industry carried approximately 20million consignments in 2018.

Cargo Revenue Accounting (CRA) plays a key role in the cargo revenue cycle. It is in a unique position in the process to protect revenue generated by cargo commercial departments and it provides the historic revenue performance information needed for managing and developing the cargo business. CRA also has to satisfy cash flow and internal control requirements of the business and all this at an acceptable unit cost. Some revenue accountants may say that CRA is undervalued and there is some truth on both sides of the debate.

Changing Needs of Cargo

Network airlines are increasingly establishing their cargo operations as businesses in their own right, either as business units managed on a contribution level or profit centre basis or legal entity subsidiaries. This trend is driven by the need for greater responsibility for profit and to compete more effectively. Consequently, business requirements are changing and demands on CRA and other finance functions that support cargo are increasing. Against this background there is a strong case for reviewing the function of CRA to ensure its purpose, scope, outputs and service levels remain aligned with the needs of the cargo businesses it serves.

Legacy of the passenger business

A cargo business with profit responsibility has differing financial management needs to its sibling passenger business and whilst some aspects of the cargo revenue cycle are similar to the passenger revenue cycle there are some fundamental differences. Apart from the obvious product distinctions, cargo has more flexibility in determining how its service is provided.

It can operate its own cargo aircraft fleet, buy-in additional sources of capacity and use different modes of transport to deliver its service. Its key markets and routes are driven by different trade flows, consignments only travel one-way, its customers and sales channels have different characteristics, its forward sales cycles are much shorter and the sales order to cash process is very different. Despite this, the similarities and ancillary nature of cargo has led to the CRA function evolving alongside passenger revenue accounting (PRA), often behind, with accounting standards being closely aligned with the passenger business. CRA has historically benefited from this alignment but this may now be a constraint on development of the function, which should be closely allied with cargo business needs.

Three areas of revenue definition illustrate why passenger accounting standards are no longer relevant to cargo and why a new paradigm is needed on CRA.

Gross revenue

The concept of gross and net revenue is well established and understood throughout the industry. Its purpose is to identify normal revenue and the level of discounting taking place. Gross cargo revenue is based on TACT rates, administered by IATA as part of The Air Cargo Tariff and Rules. These rates are also used by forwarders as a benchmark for their own prices. Net cargo revenue is based on the actual price charged by the airline to the forwarder. On closer inspection it is clear that gross cargo revenue has gradually become spurious. Average discounting by passenger businesses that do not use dynamic pricing is typically between 3% and 5%. On cargo this can be as much as 60%. It is difficult to argue that any business or industry would operate a normal and permanent level of discounting anywhere near that level. TACT rates are becoming increasingly redundant in trade between airlines and forwarders and are now mainly relevant to trade between airlines under the IATA multi-lateral agreement and for diminishing charges collect business.

As recently as 2017, IATA recognised the reality of the market and added a new Net Rates distribution service to its TACT products, which provides users with online access to airline market rates.

Most cargo businesses are now managed solely on a net revenue basis and cargo commercial managers have no interest in gross revenue based on TACT rates. So, there really is no value in accounting for it. Airline market rates are a more appropriate reflection of gross revenue against which to measure normal cargo revenue and the level of discounting on contract and spot rates. Yet CRA continues to produce gross results based on TACT, and hold back cargo revenue performance management, because its proprietary and industry systems are designed that way due to the legacy of the passenger business.

Commission

Commission is another legacy of the passenger business, which has added complexity and increased risk of revenue leakage from incorrect treatment in the billing process. Trading relationships in the freight market are different to business travel. Forwarders are in the same place in the freight supply chain as the travel agent in the retail travel supply chain. However, forwarders set their own prices and are not sales agents of the carrier. Forwarder margins include the differential between the price negotiated with the transporter and the price charged to the shipper. In this regard forwarders are more similar to tour operators in the retail travel supply chain, who act as principle to the consumer. Yet commission based on TACT rates remains a feature of CRA. Whether this continues to be driven by market conditions or is a legacy of CRA is a moot point. Nevertheless, it does seem odd that a business would inflate both its revenue and expenditure to artificially recognise commission, even if regarded immaterial. Many airlines offer 'net net' cargo rates, which more accurately reflect the forwarder status in the supply chain and explicitly excludes commission.

Route Revenue

Route revenue segmentation needs of the passenger business generally take precedent over cargo needs. Revenue performance should be viewed consistently with revenue management decisions and there is also a strong argument that consignment revenue should be accounted for on a consistent basis, irrespective of the source of capacity or mode of transport used to deliver the service. However, CRA treatment of movements on third party capacity can result in different revenue recognition for the same consignment. Take a split shipment, service recovery or consignment requiring export or import delivery to or from the airlines main hub or gateway that can be serviced by truck, own short haul flight or interlining. This is a service delivery cost trade-off decision by the airline, which should not impact revenue. But it does. The choices can not only give rise to three different total revenue amounts for the consignment but also three different revenue allocations to the main flight segment between the hub and gateway.

Interline complicates matters as airlines have traditionally treated this as a dilution of revenue consistent with the passenger business. The logic for this on passenger business is that the customer is making a choice of airline to fly on each segment and the airline issuing the ticket does so as marketing carrier and agent of the operating carrier. Cargo is different. The issuing carrier may use alternative flights, carriers or modes of transport to deliver the service at its discretion and so long as the consignment arrives on time and intact most customers do not care how it gets there. It is not acting as marketing carrier for the third-party capacity that it buys-in. In addition, under the Montreal Convention, carriage involving multiple carriers is regarded as a single operation and in the case of lost or damaged cargo the person entitled to delivery can make a claim against the issuing carrier or to the first or last carrier. So, the issuing carrier has a liability for the entire consignment. It is therefore reasonable for the issuing carrier to treat the entire freightage as its own revenue. This approach would enable the cargo business to better understand the contribution of its business segments and the value of its third-party transportation agreements. CRA today inhibits this because of the passenger legacy.

Irrespective of this, new International Financial Reporting Standard - IFRS15, Revenue Recognition came into effect on 1st January 2018. This requires businesses to identify whether it is acting as principle or agent in the transaction and to identify its performance obligations in the contract to determine its revenue. This standard has more implications for cargo businesses than on the passenger side and it is only a matter of time before the accountants and external auditors move this up the agenda.

Total cost of ownership

CRA supports three different business processes for airfreight, airmail and courier, with the former dominating. It has a higher unit cost than PRA due to business complexity, smaller economies of scale, less developed business processes and a higher prevalence of paper documentation. Because of these factors CRA is much less productive than PRA, probably by as much as 3 times at a typical airline, and a higher multiple at some. Many airlines are therefore not operating at the optimum level of performance in this area.

However, care needs to be taken when making comparisons based on headline indicators as the scope of CRA can vary greatly between airlines. Some airlines perform pricing and billing within the business whilst these activities are part of CRA in others. Some US airlines include receivables in their CRA function and system, but many airlines follow a more traditional European approach and keep receivables separate from CRA. This is an interesting comparison as it could be argued that having the consignment life cycle accounting records together in one place managed by a single service provider to the cargo business is best practice even though fewer airlines adopt this approach.

CRA clearly represents greater opportunity for unit cost reduction than PRA but this opportunity sometimes falls under management's radar when the focus is just on headcount because the numbers are higher in PRA.

CRA is a high staff resource area in airlines with significant cargo volumes and a prime area for review when CFOs are seeking to contribute to corporate profit improvement initiatives. However, the CRA supply chain is less well supported than PRA, with fewer system vendors and BPO organisations with expertise on CRA. Sometimes the easy option is to outsource CRA but if this is done on the back of weak legacy business processes the benefits can ultimately be disappointing, and occasionally worse than keeping the status quo. Greater long-term benefits are achievable with process change as the CRA function has a reliance on upstream cargo processes to provide timely and accurate consignment pricing and movement data. However, there is a high dependency on the cargo business to achieve step change improvement.

Process improvement

Although most major airlines have upgraded their cargo systems in recent years this has been from a low base due to historically low levels of investment in cargo business processes. Its ancillary status does not help as cargo has to compete with the core passenger business for a share of limited capital investment funds available. Consequently, cargo business processes across the industry generally lag behind the passenger business in fitness for purpose in the digital age. Silo systems development in the past has also contributed to sub-optimal business processes. Airlines that treat cargo as a business in its own right tend to be ahead of their rivals in addressing their legacy processes and systems. The best performing cargo operators also tend to take a more holistic approach to managing and developing their revenue cycles, which helps to optimise service delivery and financial performance, both of which are critical to staying competitive.

Consignment pricing and movement data quality has a big impact on the ability of CRA to provide an efficient and effective service to the cargo business. CRA can add value here by encouraging network conformance standards and using analytics to improve understanding of data quality and process performance across the cargo business. The old adage that if its not measured its not considered important does ring true here.

CRA is a stakeholder in the cargo revenue cycle and it can be difficult to keep pace with a cargo business that is constantly looking for new and better ways of doing business to increase revenue or profit. Being part of the corporate finance department slightly detached from the cargo business can result in the needs of CRA being overlooked on cargo business initiatives, or being an afterthought, sometimes when it is too late for CRA to positively influence a decision. This is less of an issue where there is strong finance and CRA leadership or an airline culture that fosters a collaborative approach.

eFreight

IATA's eFreight change programme is a catalyst for change on CRA. The initiative was launched in March 2009 to make the air cargo industry more competitive through significant cost reduction and shorter cycle times by driving paper out of the supply chain. With the increasing demands and threats from the internet retail giants like Amazon and Alibaba it has now become an imperative. Today, the vision is to achieve a fully digitally connected and integrated air cargo supply chain.

The electronic airwaybill (e-AWB) project and first step started in 2010. The concept of an electronic is not new; FWBs have been around since the early 1990's. The difference now is that industry protocols are enabling electronic exchange of information between all the participants in the supply chain and there is an industry-wide commitment and drive to make it happen.

Progress has been much slower than IATA originally anticipated because of regulatory challenges and technology constraints due to the prohibitive cost of change for small and mid-sized participants. More than eight years on, worldwide penetration of e-AWB is still less than 60%, reflecting how difficult it is to bring about change in the air cargo sector. Nevertheless, the e-AWB became the default (but not mandatory) contract of carriage for all cargo shipments on legally feasible and e-AWB enabled trade lanes effective 1st January 2019. Feasible trade lanes are those where the shipments origin and destination countries have ratified the same treaty and approx. 70% of worldwide consignment volume is carried on these lanes.

Whilst everyone can see the successful completion of the eFreight change programme will deliver huge gains for the air cargo industry, the downside is the added complexity and cost of a long transition for all participants. CRA itself has to run two processes, the legacy and the new, in parallel across the network and even at uplift points whilst there isn't 100% coverage due to lack of local harmonisation.

eFreight will ultimately have a positive impact on CRA not least because manual data capture will be eliminated and data quality improved, and this is already happening at many airlines. The degree of benefit for CRA depends on whether individual airlines see eFreight as a catalyst for pan-business process transformation or just a compliance exercise to stay in the game. Cathay Pacific were early adopters and the first airline to achieve 100% e-AWB penetration at its hub. A key lesson from their implementation, which incidentally helped achieve 12% productivity improvement in CRA, was that the full benefits can only be realised by internal process review, re-engineering and IT investment, with the full participation and commitment of all stakeholders in the process. Clearly, as a stakeholder CRA can play an important role in this ongoing transformation.

Consignment pricing

Consignment pricing is one of the biggest opportunities for process improvement at many airlines and this is outside the scope of the eFreight initiative.

The ideal is for consignments to be priced at the booking stage and for the booking data to be used throughout subsequent stages in service delivery and accounting. This is the design principle on which the sales order to cash process for any new business in any sector would normally be based. However, the air cargo industry is not starting from new and even some leading cargo carriers have not reached this stage in their business process development.

In many airlines, consignment pricing for CRA purposes is disconnected from the revenue management and booking processes, which is far from ideal. This often results in a gap between revenue reported and revenue expected, resulting in unproductive debates about the accuracy of the numbers instead of focus on the business issues identified by them.

Some CRA systems have been developed to include pricing due to gaps in the upstream process and systems. Whilst this may have been expedient it has put the fix in the wrong place, perpetuated the disconnection and made it more difficult to achieve the ideal. One consequence of this disconnect is a relatively high level of pricing queries from forwarders, which delays cash collection and correct recognition of revenue as well as being inherently inefficient. There is evidence that average dispute rates could be as high as 10% in some markets, with the worst airline-forwarder relationships above 20%. 2% would be considered high in some sectors! Even when consignment pricing occurs upstream at booking stage or after freight acceptance the process is not sufficiently robust to ensure minimal levels of query.

Spot pricing is a significant challenge. There is anecdotal evidence that this can be as much as 20% of consignments in some markets and fully embracing eCommerce with an electronic means of offer and acceptance would help.

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Tiralis Global Consulting recognises that the revenue cycle is a key focus of the cargo division when looking for profit improvement opportunities and when seeking to reap the benefits of eFreight. Together with logistics experts Sweethill Consultants, we are uniquely able to offer revenue cycle process review, re-design and implementation services covering sales order to cash and consignment acceptance to revenue.

If you would like to find out more, or if you are interested in exploring an ecommerce solution for spot pricing please contact us at www.tiralisglobal.com or Eddie at eeldridge@tiralisglobal.com