IFRIC

International Financial Reporting Interpretations Committee

IFRIC DRAFT INTERPRETATION D20

Customer Loyalty Programmes

Comments to be received by 6 November 2006

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D20 Comment Letters
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom

Fax: +44 (0)20 7246 6411

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Invitation to comment

The International Accounting Standards Board's International Financial Reporting Interpretations Committee (IFRIC) invites comments on any aspect of this draft Interpretation *Customer Loyalty Programmes*. Comments are most helpful if they indicate the specific paragraph to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **6 November 2006**.

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Customer Loyalty Programmes

IFRIC [draft] Interpretation X *Customer Loyalty Programmes* ([draft] IFRIC X) is set out in paragraphs 1–12. [Draft] IFRIC X is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 1 and 8–10 of the IFRIC *Preface*.

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References

- IAS 18 *Revenue*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IAS 38 *Intangible Assets*

Background

1 Customer loyalty programmes are used by entities to provide customers with incentives to buy their products. Each time a customer buys goods or services, or performs another qualifying act, the entity grants the customer award credits (variously described as 'points', 'air miles' etc). The customer can redeem the award credits for awards such as free or discounted goods or services.

2 The programmes operate in a variety of ways. Customers may be required to accumulate a specified minimum number or value of award credits before they are able to redeem them. Award credits may be linked to individual purchases or groups of purchases, or to continued custom over a specified period of time. The entity may operate the customer loyalty programme itself or participate in a programme operated by a third party. The awards offered may include goods and services supplied by the entity itself and/or rights to claim goods or services from another vendor.

Scope

3 This [draft] Interpretation addresses accounting by entities that operate or otherwise participate in customer loyalty programmes for their customers. It addresses sales transactions in which the entities grant their customers award credits that, subject to meeting any further qualifying conditions, the customers can redeem in future for free or discounted goods or services.

Issues

4 The issues addressed in this [draft] Interpretation are:

(a) whether the entity's obligation to provide free or discounted goods or services should be recognised and measured by (i) allocating some of the consideration received or receivable from the initial

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sales transaction to the award credits and deferring the recognition of revenue (ie applying paragraph 13 of IAS 18), or (ii) providing for the estimated future costs of supplying the goods or services (applying paragraph 19 of IAS 18); and

(b) if consideration is allocated to the award credits, how much should be allocated to them, and when it should be recognised as revenue.

Consensus

5 An entity shall apply paragraph 13 of IAS 18 and account for award credits as a separately identifiable component of the sales transaction(s) in which they are granted (the 'initial sale'). The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the components, ie the goods and services sold and the award credits granted.

6 The allocation shall be made by reference to the relative fair values of the components, ie the amounts for which each component could be sold separately.

7 The fair value of the award credits may be estimated by reference to the discount that the customer would obtain when redeeming the award credits for goods or services. The nominal value of this discount would be reduced to take into account:

(a) any discount that would be offered to customers who have not earned award credits from an initial sale;

(b) the proportion of award credits that are expected to be forfeited by customers; and

(c) the time value of money.

If customers can choose from a range of different awards, the fair value of the award credits will reflect the fair values of the range of available discounts, weighted in proportion to the frequency with which each is expected to be selected.

8 The entity shall recognise revenue in respect of the award credits either:

(a) in the periods, and reflecting the pattern, in which award credits are redeemed; or

(b) if a third party assumes the obligation to supply the awards to the customer, when that third party assumes the obligation.

The amount of revenue recognised in (a) will be based on the number of award credits that have been redeemed relative to the total number expected to be redeemed.

9 Whether and when a third party assumes the obligation to supply awards to the customer depends on the terms of its agreement with the entity. The third party might assume the obligation as soon as the award credits are granted, in which case the entity recognises revenue at the same time as the initial sale. In contrast, if customers can choose to claim awards from either the entity or the third party, the third party might assume the obligation only when a customer chooses to claim awards from it.

10 If at any time the unavoidable costs of meeting the obligation to supply the awards are expected to exceed the consideration received and receivable for them (ie the consideration allocated to the award credits at the time of the initial sale that has not yet been recognised as revenue plus any further consideration receivable when the customer redeems the award credits), the entity has an onerous contract. An additional liability shall be recognised for the excess in accordance with IAS 37. The need to recognise such a liability could arise if the expected costs of supplying awards increase, for example if the entity revises its expectations regarding forfeiture rates.

11 Customer loyalty programmes may create or enhance customer relationship intangible assets. Such assets are recognised only if the recognition criteria in IAS 38 are met.

Effective date and transition

12 An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date to be set at three months after the Interpretation is finalised]. Earlier application is encouraged. If an entity applies the [draft] Interpretation for a period beginning before [date to be set at three months after the Interpretation is finalised], it shall disclose that fact. The [draft] Interpretation shall be applied retrospectively.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, draft IFRIC X.

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Issues

BC2 Customer loyalty programmes are widespread, being used by businesses as diverse as supermarkets, airlines, telecommunications operators, hotels and credit card providers. IFRSs lack detailed guidance on how entities should account for the awards offered to customers in these programmes. As a result, practices have diverged.

BC3 The main area of diversity concerns the recognition and measurement of obligations to give customers free or discounted goods or services if and when they redeem award credits.

BC4 One view is that the obligation should be recognised as an expense at the time of the initial sale and measured by reference to the amount required to settle it, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In support of this view, it is argued that:

(a) customer loyalty programmes are marketing tools designed to enhance sales volumes. The costs of the programmes are therefore marketing expenses.

(b) the value of awards is often insignificant in comparison with the value of the purchases required to earn them. The obligation to exchange award credits for awards is therefore not a significant element of the sales transaction. Thus, when the initial sale is made, the entity has met the conditions set out in IAS 18 *Revenue* for recognising revenue from that sale. Paragraph 16 of IAS 18 indicates that a selling entity can recognise revenue before it has completed all of the acts required of it under the contract, providing it does not retain the significant risks and rewards of ownership of the goods sold. Paragraph 19 envisages that expenses relating to the sale, including those still to be incurred, should be recognised at the same time as the revenue.

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BC5 A second view is that some of the consideration received from the customer should be allocated to the award credits and deferred as a liability until the entity fulfils its obligations to deliver awards to customers. The liability would be measured by reference to the value of the award credits to the customer (not their cost to the entity) and recognised as a deferral of revenue (not an expense). In support of this view, it is argued that:

(a) award credits are an element of the market exchange of economic benefits between the entity and the customer. They represent rights granted to a customer, for which the customer is implicitly paying. They can be distinguished from marketing expenses because they are granted to the customer as part of a sales transaction.

(b) award credits are separately identifiable from the other goods or services sold as part of the initial sale. Paragraph 13 of IAS 18 states that:

> The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed.

Because the awards are not delivered to the customer at the same time as the other goods or services, it is necessary to divide the initial sale into components and apply the recognition criteria separately to each component in order to reflect the substance of the transaction.

BC6 A third view is that the accounting should depend on the nature of the customer loyalty programme. The criteria for determining which accounting treatment should be adopted could refer to the relative value or nature of the awards, or the method of supplying them. Award credits would be regarded as marketing expenses if, say, their value were insignificant and/or they were redeemable for goods or services not supplied by the entity in the course of its ordinary activities. In contrast, award credits would be regarded as a separate component of the initial sales transaction if their value were significant and/or they were redeemable for goods or services supplied by the entity in the course of its ordinary activities.

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Consensus

Attributing revenue to award credits

BC7 The consensus reflects the second view, described in paragraph BC5. In reaching its consensus, the IFRIC noted that:

(a) the first and second views apply different paragraphs of IAS 18. The first view (paragraph BC4) applies paragraph 19 to recognise the cost of the awards at the time of the initial sale. The second view applies paragraph 13 to identify the award credits as a separate component of the initial sale. The issue is therefore to identify which of the two paragraphs should be applied. IAS 18 does not give explicit guidance. However, the aim of IAS 18 is to recognise revenue when, and to the extent that, goods or services have been delivered to a customer. In the IFRIC's view, paragraph 13 applies if a single contract requires two or more separate goods or services to be delivered at different times: it ensures that revenue for each item is recognised only when that item is delivered. In contrast, paragraph 19 applies only if the entity has to incur further costs directly related to items *already delivered*, eg to install goods or meet warranty claims. In the IFRIC's view, loyalty awards are not costs that directly relate to the goods and services already delivered—rather, they are separate goods or services delivered at a later date.

(b) the accounting treatment required when customer loyalty award credits are accounted for as a separate component is consistent with that generally applied to similar transactions that are outside the scope of the draft Interpretation.

(c) the third option, described in paragraph BC6, in which the accounting treatment depends on the nature or relative value of the awards, would be difficult to justify conceptually. It can be argued that the substance of the incentives is the same, whatever their form or value. A dividing line could lead to inconsistencies and accounting arbitrage. Particular difficulties could arise if a programme offered customers a choice of awards, only some of which would be supplied by the entity in the course of its ordinary activities.

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Allocation method

BC8 IAS 18 requires revenue to be measured at the fair value of the consideration received or receivable. Hence the amount of revenue attributed to award credits should be the fair value of the consideration received for them. The IFRIC noted that this amount is often not directly observable because the award credits are granted as part of a larger sale. In such circumstances, it must be estimated by allocating the total consideration between the award credits and other goods and services sold, using an appropriate allocation method.

BC9 IAS 18 does not prescribe an allocation method for multiple-component sales. However, its overall measurement objective is to determine the amount the customer is paying for each component, which may be estimated by drawing on the entity's experience of transactions with similar customers. Hence, the draft Interpretation proposes that the consideration received for sales incorporating award credits should be allocated between the components by reference to their relative fair values. The IFRIC concluded that this method satisfies the overall measurement objective of IAS 18.

BC10 Paragraph 7 of the consensus includes guidance on how the fair value of award credits *may* be estimated, ie by reference to the discount that the customer would obtain when redeeming the award credits for goods or services. However, the IFRIC recognises that, in some circumstances, other estimation techniques may be available. For example, if the entity engages a third party to supply awards and pays the third party for each award credit it grants, it could estimate the fair value of the award credits by reference to the amount it pays the third party, adding a reasonable profit margin. Judgement is required to select and apply the technique that satisfies the requirements of paragraph 6 of the consensus and is most appropriate in the circumstances. Hence, the draft Interpretation does not impose any specific technique.

Revenue recognition

BC11 The consideration allocated to award credits represents the amount that the entity has received for accepting an obligation to supply awards if customers redeem the credits. The estimate of this amount reflects both the value of the awards and the entity's expectations regarding the proportion of credits that will be redeemed, ie the risk of a claim being

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made. The entity has received the consideration for accepting the risk, whether or not a claim is actually made. Hence, the draft Interpretation requires revenue to be recognised as the risk expires, ie in the periods, and reflecting the pattern, in which award credits are redeemed.

BC12 After granting award credits, the entity may revise its expectations about the proportion that will be redeemed. The change in expectations does not affect the consideration that the entity has received for supplying awards: this consideration (and hence the revenue) was fixed at the time of the initial sale. However, it may affect the costs the entity will incur to supply awards. If redemption rates are expected to increase to the extent that the unavoidable costs of supplying awards will exceed the consideration received and receivable for them, the entity has an onerous contract. The draft Interpretation therefore highlights the requirement of IAS 37 to recognise an additional liability for the excess.

Awards supplied by a third party

BC13 Some customer loyalty programmes offer customers awards in the form of goods and services supplied by a third party. For example, a grocery retailer may offer customers an option to redeem award credits for air miles or a voucher for free goods from an electrical retailer. The IFRIC noted that, depending on the terms of the arrangement, the reporting entity (the grocery retailer in this example) may have retained few, if any, obligations in respect of the supply of the awards—the obligation to supply the awards to the customer may have been assumed by the third party. The IFRIC concluded that, in such circumstances, the customer is still receiving the benefits of—and hence implicitly paying the entity consideration for—the rights to future awards. However, if the entity has no obligations in respect of the delivery of the awards, it should not defer revenue.

BC14 The IFRIC considered whether, in such circumstances, the entity may in substance be collecting the consideration on behalf of the third party, ie like an agent for the third party. If so, it could be argued that the gross consideration attributable to the award credits does not represent revenue for the entity. Rather, the entity's revenue may be only the net amount it retains on its own account, ie the difference between the customer consideration allocated to the award credits and the amount paid or payable by the entity to the third party for supplying the awards. The IFRIC decided not to address this presentation issue within the draft Interpretation because the general issue of whether and when revenue should be recognised net rather than gross is the subject of a separate IFRIC project.

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