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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.*

*Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**IFRIC meeting: March 2006, London**

**Project: Customer Loyalty Programmes (Agenda Paper 8)**

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At its January meeting, the IFRIC requested a paper analysing the main issues relating to customer loyalty programmes:

Two main issues are covered in this paper:

- 1 what is the dividing line between IAS 18.13 (multiple elements) and IAS 18.19 (provisions for future costs)?
- 2 how to measure the rights granted under a loyalty programme arrangement?

## **1 Should loyalty programmes be considered as multiple sales arrangements under IAS 18 §13?**

- 1 Paragraph 13 indicates that, “*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*”. This issues paper examines both sides of the issue: A - the economic substance of multiple sales arrangements, B - the separability of the identifiable components.

### **1A The economic substance of customer loyalty programmes**

- 2 This section discusses whether, and in what circumstances, the rewards given to customers in customer loyalty programmes are revenue-generating supplies in their own right, or costs of securing other sales. The discussion focuses on an example involving a range of simple programmes:

An entity sells machines for \$100 each. Customers are entitled to join one of the following loyalty programmes:

*Programme A: Volume rebates*

When a customer has purchased 10 machines, he receives a 10% rebate.

*Programme B: Additional goods*

A customer earns 1 loyalty point with each machine purchased. When he has accumulated 9 loyalty points, he is entitled to a free machine.

*Programme C: Free gifts*

A customer earns 1 loyalty point with each machine purchased. When he has accumulated 9 loyalty points, he is able to choose free gifts to a value of \$90. The gifts are not normally sold by the entity.

- 3 Let us assume initially that customers (i) can join only one of the programmes (ie they do not have a choice of rewards); and (ii) always qualify for, and take up, their rewards—choice and forfeiture are addressed later. For simplicity, the time value of money is also ignored.

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- 4 Economically, the programmes above are similar. After spending \$900:
- a) customers in programmes A and B have received 10 machines, paying an average of \$90 per machine, and
  - b) customers in programme C have received 9 machines, plus other goods worth \$90.
- 5 The substance of the rewards in Schemes B and C (free machine or free gift) could be regarded in one of two ways:
- a) *as costs of securing sales*, ie as marketing/selling expenses incurred to sell nine machines for \$100 each; or
  - b) *as goods or services supplied under the terms of a sales contract*, ie as revenue-generating activities in their own right. The customer is paying the entity for both the original goods or services and the incentives.
- 6 There is a view that the substance of the rewards may depend on their nature. The determining factor may relate to the objective of different types of reward, ie whether their effect is to reduce the unit price, or increase the appeal, of the underlying goods or services
- 7 Programme B above has the effect of reducing the unit price of the entity's machines, not making the machines any more appealing than they otherwise would be. For scheme B, it can readily be argued that the substance of the programme is the same as that of a volume discount. Hence, it is readily argued that each of the ten machines—including the free one—should be regarded as generating revenue of \$90.
- 8 However, Programme C may be more difficult to analyse. The free gift may be a good or service that the customer would not otherwise have bought. So it is not so obvious that the customer has paid anything for it. The purpose of free gifts can be to make mundane products (eg banking services) more pleasurable for the customer to buy. So they could be viewed as increasing the appeal (and implicitly

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value) of the underlying product or service, not generating revenue in their own right. This view perhaps has most resonance when the free gift is of low relative value and is not normally sold by the entity.

- 9 In favour of this view is the fact that the company does not otherwise carry the proposed goods or services and that, therefore, the customer has no intention to buy the goods and services of the company, nor do such sales participate to the building of the revenue of the company.
- 10 Against this view, it can be argued that even programmes involving rights to goods or services provided by third parties give benefits to the customer, for which the customer should be regarded as paying consideration. However, the situation is not different from the one where a company grants a give away to a customer prior to a sale, irrespective of any customer loyalty programme.
- 11 Others argue that it could be difficult to define the point on the spectrum of loyalty programmes at which the rewards changed in substance from being revenue-generating goods or services to being expenses of securing a sale of other goods or services. The substance could perhaps be judged by reference to various factors—eg the relative value of the rewards, whether the rewards are otherwise sold by the entity (or related parties?) in the normal course of business, whether they are supplied by the entity itself or by a third party provider.
- 12 On the basis of these arguments, the staff's view is that most loyalty rewards should be treated as part of the sale itself: either reducing the customer consideration (volume rebates) or providing additional goods and services to which some of the consideration implicitly relates.
- 13 However, in some cases, the company offers, via its loyalty programmes, goods or services it does not otherwise provide and which therefore do not contribute to the building up of its revenue. Also, in these instances, customers have initially no intention of buying from the company the goods and services provided via the loyalty programme. In these cases, the nature of the free or discounted goods and

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services that will in the end be provided to the customers as a reward for their participation in the loyalty programme is more that of a sale incentive. Criteria that can help differentiate both types of scheme are :

- does the company turn to an external provider to deliver the promised goods and services,
- the relative value of the goods and services provided as a reward compared to the original amount of the sale.

***Questions for IFRIC members***

14 *Do you view customer loyalty rewards as:*

- a) *goods and services supplied as part of a sales transaction;*
- b) *costs of securing sales of other goods and services; or*
- c) *possibly either, depending on the nature of the programme?*

15 *If you believe that the answer depends on the nature of the programme, which factors (eg of those in paragraph 11) would you use to distinguish between rewards that generate revenue and those that are expenses of securing other sales?*

**1B—Whether loyalty rewards are separately identifiable components**

16 This section only deals with arrangements which fall outside the scope of paragraph 13 above.

17 IAS 18.13 states that “...*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*

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*servicing, that amount is deferred and recognised as revenue over the period during which the service is performed”.*

- 18 The difficult question is what is meant by a ‘separately identifiable component’. The example in the second sentence quoted above states that the amount of the total consideration attributable to different components is identifiable, but it is not clear whether this is intended to imply a general rule.
- 19 The IASB has been considering the question as part of its project to develop a new revenue standard. Various criteria have been suggested for dividing a contract into components. These could be based for example, on:
- a) whether there are two or more goods or services that could be bought / sold separately; or
  - b) whether the entity would be entitled to receive (or keep) payment for one good or service, if it delivered it and then failed to deliver the other goods or services.
- 20 These alternative criteria could give different answers. For example, suppose a telecoms contract gives a customer a telephone and unlimited calls in return for a fixed monthly fee. Usually, the telephone and calls could be sold separately. But, in such a contract, the telecoms company could not usually claim payment for the telephone if it did not deliver the unlimited free calls.
- 21 IAS 18 could be interpreted using either of these criteria. Paragraphs 16 and 19 appear to envisage that installation and warranties supplied with goods are not separate components. This guidance could reflect that some warranties (eg standard manufacturers’ warranties) and installation services are typically not sold (or priced) separately from the goods with which they are supplied. Or that the entity’s right to be paid for the goods is contingent on its fulfilling its warranty or installation obligations.

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- 22 The IFRIC has previously decided not to take on projects that would require it to interpret the meaning of ‘separately identifiable components’ in paragraph 13. An Interpretation on that issue could require changes of practice across a number of sectors. And the IFRIC has said that it does not wish to pre-empt the outcome of the Board’s deliberations.
- 23 However, it appears that the IFRIC could reach a conclusion on customer loyalty programmes without having to interpret exactly what ‘separately identifiable components’ should be taken to mean. It can be argued that:
- a) the rewards provided under loyalty programmes meet any of the alternative interpretations of ‘separately identifiable’. Because the customer may or may not receive the loyalty rewards when making the initial purchases, the rewards are inherently separable from the initial goods and services: they (a) are capable of being sold separately; (b) have an identifiable price; and (c) do not represent a continuing involvement in the original goods and services;
  - b) the conclusion that the rewards are separately identifiable would apply irrespective of whether they were provided by the entity or by a third party provider. The identity of the supplier has no bearing on whether the incentives are separately identifiable.
- 24 The IFRIC could use these arguments as a basis for a conclusion that goods and services provided under loyalty programmes should be treated as separately identifiable components of sales transactions. Part of the overall consideration receivable from the customer would be allocated to the obligation to provide loyalty rewards, and recognised when the rewards were delivered to the customer.
- 25 The conclusion of section 1 is as follows:

*In order to correctly apprehend the substance of loyalty cards/programmes, it is necessary that companies, when accounting for such programmes, apply separately the recognition criteria for revenue arising from the sale of the goods*

*Application of IAS 18 to customer loyalty schemes and services purchased by customers and for the rights received as part of a loyalty cards/programme.*

*In some cases, the company offers, via its loyalty programmes, goods or services it does not otherwise provide and which therefore do not contribute to the building up of the revenue of the company. In such cases, the rights offered as part of the loyalty programme are not directly linked to a future sale of the company and the nature of the free or discounted goods and services that will be given to the customer as a reward for its participation in the programme is more that of a sale incentive.*

### ***Questions for IFRIC members***

*Do you agree with the general conclusion of part 1? If not, why not.*

## **2 Recognition and measurement issues**

26 Assessing whether and how much revenue should be deferred, or if there is a need for a provision for expenses still to be incurred, is the next step once it has been determined if customer loyalty cards/programmes are to be considered as multiple arrangements under paragraph 13 of IAS 18.

### **2A Multiple sales arrangements**

27 When customer loyalty plans are multiple sale arrangements, a multiple steps approach is required to determine the amount of revenue – if any – which is to be deferred:

- a) *Step 1:* Apply paragraph 14 (or 20) to each separately identified component: determine whether the conditions for recognising revenue attributable to that component have been met. Apply paragraph 19 if necessary

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- b) *Step 2:* Determine the amount of the fair value of the consideration received which is to be allocated to the identified component of the transaction, the revenue of which is to be deferred

***Question for the members of the IFRIC:***

*Do you support the approach as described by the staff?*

***Step 1—Application of paragraphs 14 and 19 to loyalty cards/programmes that fall under the scope of §13***

- 28 Having identified the original goods sold and loyalty incentives as separate components the entity would then apply paragraph 14 of IAS 18 to determine when the criteria for recognising revenue were met for each component.
- 29 Only when the conditions in paragraph 14 had been met in respect of the incentives, would the consideration allocated to them be recognised as revenue. At that point, paragraph 19 would also be applied and any further costs still to be incurred would be recognized.
- 30 Conditions (a), transfer of all significant risks and rewards of ownership, and (e), reliable measurement of costs, seem to have a determining influence in assessing if the conditions of paragraph 14 are met for the recognition of the revenue allocated to the rights granted to the customer as rewards for its participation in the loyalty programme.
- 31 With regard to (a) two views have been expressed :
- some consider that the company has transferred all the rights and rewards pertaining to the rights granted to the customer, who is now fully responsible for their exercise – notably, he can choose not to make the further purchases that would entitle him to the free or discounted goods or services,

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- others consider that the final surrender of the goods and services is to be considered, as the economics of loyalty cards/programmes is to provide, in the end, free or discounted goods and services.

With regard to (e), there seems to be a degree of uncertainty as regards the measurement of the cost to be incurred in respect of the rights granted to the customer.

Therefore, it is the staff view that the conditions of paragraph 14 of IAS 18 are not met with regard to the recognition of revenue. Paragraph 19 is thus to be applied and the consideration received in exchange for the grant of the rights is to be recognized as a liability.

***Question to the IFRIC members:***

*Do you agree with the staff view with regard to the application of §14 of IAS 18 to customer loyalty programmes that have to be considered as multiple element sales?*

***Step 2—Evaluation of the consideration received in exchange for the grant of the rights***

- 32 Consistent with paragraph 9 of IAS 18 the revenue attributable to the loyalty rewards should be an estimate of the consideration receivable from the customer for them. The staff proposes that, in order to simplify the accounting treatment of loyalty plans, that consideration be deemed to be the fair value of the rights granted. The evaluation of this fair value should take into account :
- a) The fair value of the goods and services promised to the customer – being the most advantageous retail price available to the customer,
  - b) The probability that the customer does not reach the required threshold to be entitled to the goods and services,
  - c) The probable forfeiture rate.

**33** *Question to the IFRIC members:*

*Do the IFRIC members agree with the staff analysis? If not, why not? What alternative would you propose?*

**2B Rewards supplied by a third party provider**

34 When the rights granted have the economic nature of sale incentives, the sale is to be considered as a whole.

35 Conditions (a) and (e) of paragraph 14 have been met, for the following reasons :

- a) the risks and rewards pertaining to the purchased goods or services have been transferred to the customer,
- b) as the company is turning to an external provider, it has a reliable market price for the evaluation of the future expenses pertaining to the sale.

36 Therefore, paragraph 19 of IAS 18 applies and revenue – the whole consideration received – and expenses – what remains to be paid to the external provider – are booked simultaneously.

**37** *Question to the IFRIC members:*

*Do you agree with the staff analysis? If not, why not?*