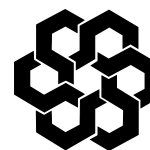

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

Project: **IAS 18 - Customer Loyalty Programmes (Agenda Papers 3/3(i)/3(ii))**

PAPER 3 — OVERVIEW OF PAPERS

Objective

1 This set of papers analyses comments received on draft Interpretation D20 *Customer Loyalty Programmes*. It includes comments on three aspects of the draft Interpretation:

a) the need for an Interpretation;

b) the overall approach proposed (which would require award credits to be accounted for as a separate component of the sale in which they are granted); and

c) the proposed scope.

2 The objective of the meeting is to decide whether to proceed towards a final Interpretation based on the proposed approach, and if so, whether to alter its scope. This set of papers contains all the comments that the staff regard as pertinent to these decisions. If the IFRIC decides to proceed, the staff will prepare further papers analysing comments received on other aspects of the draft Interpretation, ie the proposed method of applying the 'separate component' approach, transitional arrangements and effective date.

Overview of D20

3 D20 *Customer Loyalty Programmes* addressed accounting by entities that operate or otherwise participate in customer loyalty programmes and grant their customers points, air miles or other award credits when the customers buy goods or services. Specifically, it addressed how such entities should recognise and measure their obligations to provide free or discounted goods or services if and when the customers redeem the award credits.

4 The rationale for issuing an Interpretation was summarised in the Basis for Conclusions:

> 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.

5 The main area of divergence, and hence the issue addressed in the draft Interpretation, was 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 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).

6 The draft Interpretation proposed approach (i). It went on to specify how much of the sale proceeds should be allocated to the award credits and when the proceeds so allocated should be recognised in the income statement.

Overview of comments

7 Fifty seven comment letters had been received by the end of November (3½ weeks after the comment deadline).

8 There was widespread agreement that the IFRIC should issue an Interpretation on this topic. [More details have been provided to the IFRIC members in an Appendix to Paper 3. However these have been omitted from the observer note.]

9 However, there was less agreement with the basic consensus reached, ie that, irrespective of the nature of the loyalty programme, award credits should be accounted for as separate components of the sale in which they are granted (the separate component approach). Paper 3(i) addresses the many comments received on this matter.

10 There were also a variety of suggestions made about the scope of the draft Interpretation. These are addressed in Paper 3(ii).

PAPER 3(i) — SEPARATE COMPONENT APPROACH

Purpose of paper

1 Paper 3(i) analyses comments received on the proposal in D20 to require customer loyalty award credits to be accounted for as separate components of the sale in which they are granted.

2 The purpose of the paper is to help the IFRIC decide whether to proceed towards a final Interpretation based on this approach.

D20 proposal

3 The draft Interpretation proposed that:

> 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.

4 Paragraph BC7(a) explained why the IFRIC decided that award credits should be regarded as separately identifiable components:

> …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

Comments

Overview

5 As this was the main proposal underlying the draft Interpretation, 52 of the 57 commentators expressed an overall view. Views were not always clear cut—some support was qualified, some opposition was tentative and some commentators opposing D20 did not clearly articulate a preferred alternative.

6 The names of the commentators are listed in an appendix to Paper 3(i). [This appendix has been omitted from the observer note.]

A *Supporters of proposed separate-component approach*

7 Sixteen commentators supported the proposed approach. Of these, one, the *German Accounting Interpretations Committee (CL43)* was not entirely persuaded that award credits would be separately identifiable components of the sales transaction in all circumstances. However, it acknowledged that it could not find a suitable dividing line between award credits that were separately identifiable components and those that served only marketing purposes. And it agreed with the IFRIC that possible dividing lines that had been discussed so far (eg based on the value of the awards or the way in which they are supplied) were ambiguous and lacked principle-based foundation.

8 The 15 other supporters of the approach implicitly or explicitly accepted the conceptual arguments for the view that loyalty award credits are separately identifiable components of the sales in which they are granted:

> We support the consensus in the Draft Interpretation, in so far that it applies to customer loyalty programmes that represent multiple sales, as we think the logic set out for identification and measurement of separately identifiable components in a transaction is irrefutable. We believe the IFRIC has interpreted the distinction between paragraph 13 and paragraph 19 in IAS 18 *Revenue* appropriately. Paragraph 13 of IAS 18 applies when a single contract requires two or more separate goods or services to be delivered at different times. In contrast, paragraph 19 of IAS 18 applies when an entity has to incur further costs related to items already delivered. An entity would not normally incur costs related to award credits at the time of the initial transaction because the entity has not provided the goods or the services to the customer at that time but rather when the customer redeems the award credits. Award credits that are provided as part of a transaction should therefore follow the accounting requirements in paragraph 13 and revenue accounted for when the entity delivers the goods or services, as a result of the award credits, to the customer. *CL31 Deloitte*

> In expressing this support, we are most persuaded by the argument at BC7 that IAS18.13 applies if a single contract requires two or more separate goods or services to be delivered. *CL9 Grant Thornton*

> We see additional arguments for this approach based on the nature of the schemes themselves. While schemes operate in various different ways, participation in them is generally a 'choice' of the customer. This indicates that the award credits are considered to be of value to those customers, representing rights granted to them, separate from the purchase transaction, rather than advertising or marketing expenses. Further, award credits are increasingly being purchased by one entity from another for issue to the purchaser's customers, again indicating that there is separate value in such award credits. *CL38 Ernst & Young*

9 Several of the commentators qualified their support because of the practical difficulties involved in measuring the fair values of award credits, and hence in the reliability of the amount of revenue allocated to them. Some of these commentators suggested that the IFRIC:

a) consider whether an alternative approach (cost accrual) could be permitted for circumstances in which significant assumptions reduce the reliability of revenue allocations, and the award credits are relatively insignificant elements of the overall transactions. *CL38 Ernst & Young*

b) conduct field tests and/or consult all affected industries to test the feasibility and practical implications of the proposals. *CL38 Ernst & Young*

c) remind readers that the Interpretation need not be applied to immaterial items, and that award credits might be less material than they appear at first sight. Air miles, for example, are less valuable than their nominal values because of restrictive conditions attaching to their use. *CL4 UK Urgent Issues Task Force, CL30 Inst. Chartered Accountants in England & Wales, CL34 The Hundred Group of Finance Directors.*

B *Advocates for a mixed approach*

10 Twenty commentators thought that the separate component approach should be required only for some types of loyalty programme, with a cost accrual approach being permitted or required for others. However, these commentators did not all envisage the dividing line being drawn in the same way—the staff identified three different views amongst this group.

Marginally-managed programmes

11 One commentator, an airline, identified three principal types of customer loyalty programme:

	Type	Nature	Example (added by staff)
1	Marginally-managed	Offer participants limited rights to further goods or services from the entity, but only goods or services that would otherwise expire unused.	Air miles that can be used only for travel on routes and dates offered at discretion of airline.
2	Monetised	Offer participants a currency giving unlimited rights to any further goods or services sold by the entity.	Supermarket points, where customers can exchange 250 points for $2.50 off any future purchase.
3	Partner	Offer participants rights to goods or services from a third party.	Credit card points that can be exchanged for goods from an electrical retailer.

12 The airline advocated retaining the cost accrual approach for marginally-managed customer loyalty programmes. The grounds for doing so would be that, for such programmes, the amount of revenue that should be deferred and the timing of its release often cannot be measured reliably, impairing the comparability of accounts. Hence a deferred revenue approach would not produce the benefits needed to justify the substantial additional costs.

13 In support of this view, the airline noted that:

a) there are significant practical difficulties in measuring the fair values of the award credits in marginally-managed programmes. The programmes can be complex, the awards supplied depend on the redemption preferences of the holder and those allowed by the airline, and the value of the awards is highly uncertain because they would not otherwise be sold.

b) because the programme operators have so much discretion over the awards offered, the fair values of the award credits fluctuate with time. Points that have been outstanding for different periods of time will have been assigned different fair values, and hence revenue. Historically, the airline has measured its liabilities by pooling all outstanding points. Under the deferred revenue approach, where the values of points are fixed at the time of the initial sale, pooling will no longer be possible.

c) a separate component approach could give rise to additional Goods and Services Tax (GST) / Value Added Tax (VAT) administration burdens. In many jurisdictions, GST or VAT is levied on domestic flights but not international flights. At present, the whole price of a flight ticket is attributed to that ticket, and the total transaction is either taxable or not. If revenue were attributed to loyalty points, the airlines may have to implement new systems and processes to issue tax invoices and adjustment notes for the deemed consideration that relates to points used for domestic flights.

Scope out awards comprising items not sold in course of ordinary activities

CL14 Representatives of French Business[1]	CL28 Syngenta	CL42 Mazars
CL19 Belgian ASB	CL36 French CNC	CL44 Swiss Holdings
CL26 Confederation of European Business	CL40 Nestlé	CL47 ASB Japan

14 The above nine commentators focused primarily on the method of supply of the awards. They agreed with the D20 proposals for loyalty programmes in which the entity was required to supply awards itself, and the awards comprised goods that were also sold by the entity in the course of its ordinary activities. Such programmes would include, for example, air miles granted for free travel or supermarket points redeemable for further supermarket products.

[1] ACTEO (Association pour la participation des enterprises Françaises à l'harmonisation comptable internationale), AFEP (Association Française des Enterprises Privées), MEDEF (Mouvement des Enterprises de France).

15 However, these commentators did not agree that D20 should apply to programmes in which of the awards would:

a) be supplied by third parties; and/or

b) comprise goods that, though supplied by the entity, were not produced and separately marketed by the entity in the course of its ordinary activities. An example would be free wine glasses awarded by petrol retailers.

16 Some of the commentators suggested that the IFRIC should exclude such programmes from the scope of the Interpretation. Others suggested that the Interpretation should require a cost accrual approach for them instead. Some also thought that the costs should be deducted from revenue (in the same way as cash rebates) rather than being presented as separate expenses.

17 Arguments put forward in support of these views were that:

a) paragraph 13 of IAS 18 requires the recognition criteria to be applied to separately identifiable components of single transaction only if necessary to reflect the substance of the transaction. If the awards are not products or services normally sold in the course of the entity's ordinary activities, they do not generate revenue. They do not have the substance of a sales transaction. They are in substance marketing costs. Revenue should be an indicator of the level of economic activity of an entity with its customers arising in the course of its ordinary activities. *CL36 CNC, CL47 ASB Japan*

b) if the third party products or services are not sold or marketed separately and in their own right by the entity they are economically equivalent to a cash rebate. *CL28 Syngenta*

c) revenue should reflect sales volumes that are sensitive to the economic parameters of the sectors in which the entity operates. There is no market reality in, for example, customers transacting with airlines to purchase pieces of luggage. *CL26 Confederation of European Business*

d) awards should give rise to revenue only if they represent a direct interest for the customer and replace sales that would otherwise be made at market conditions. *CL42 Mazars*

e) the argument that a mixed approach is not workable (BC7(c) of D20) is not convincing:

> We believe that it will often be quite clear when the awards are not products sold by an entity in the ordinary course of business, so the dividing line will not be difficult to fix. *CL36 French CNC*

f) the IFRIC has not included in its basis for conclusions any conceptual argument for rejecting a mixed approach. *CL26 Confederation of European Business*

18 It appears that at least one of the respondents did not realise that D20 would *not* require revenue to be deferred if the entity engaged a third party to supply the awards and the third party assumed the obligation from the outset[2]:

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2 Paragraph 8(b) of D20 would require revenue to be recognised when the third party assumed the obligation, ie at the time of the initial sale. The entity would then apply paragraph 19 of IAS 18 to also recognise the cost of the fee that would immediately become payable to the third party.

Apply cost accrual approach where awards are incidental

CL3 Dutch Accounting Standards Board	CL49 Group of 100, Australia
CL29 German Institut der Wirtschaftsprüfer	CL51 KPMG
CL46 Danish Accounting Standards Committee	CL54 European. Fed Accountants (FEE)

19 The above six commentators also took the view that the accounting treatment should depend on the nature of the customer loyalty programme. However, they did not focus so much on whether the supply of awards was a revenue-generating activity, although this issue was addressed by some of them. Rather, they focused more on the IFRIC's conclusion that the awards were necessarily 'separately identifiable components' that needed to be recognised separately to reflect the substance of the transaction.

> In our view, it is necessary to make a distinction as to whether the sales transaction actually relates to the supply of more than one main good or service (one of which being the award credits), or to only one main good or service with corresponding incidental award credits. …when the award credits granted are incidental to the main good or service, which will frequently be the case, income has to be recognised in total at the time of the initial sale, since all revenue recognition criteria of IAS 18 will have been fulfilled; in particular, as the entity will have transferred all significant risks and rewards attaching to the main goods or services sold. *CL29 German Institut der Wirtschaftsprüfer*

> In practice, some programmes are only designed to obtain the first sale and may not deliver substantial additional value to the customer. A customer may not want to buy and the seller may not normally sell the additional products or services, if they were stand alone products. Consequently we disagree that a customer loyalty programme always represents a separable identifiable component of revenue. Instead we believe that even if the goods or services are delivered at different times, it may be completely linked to the initial transaction depending on the nature of the programme. *CL46 Danish Accounting Standards Committee*

> We note that paragraph 13 [of IAS 18] should be applied to all transactions as a first step to identify whether there are separate

> components of a transaction. …We therefore believe that the real issue is what paragraph 13 envisages as separately identifiable components and what separation criteria should be used. We note that D20 does not answer this question but rather specifies that all loyalty programmes within the scope have to be separated.
>
> Since IFRIC has not articulated its understanding of the criteria for separation of revenue components, we struggle to understand the reason why customer loyalty awards never can be considered an incidental cost associated with a delivered item, which would then be accounted for in accordance with IAS 18.19. Some programmes may be designed primarily to elicit the initial sale and, from the customer perspective, may not deliver substantial additional value. A customer may not want to buy two products. The substance of such transactions may be that of a single sale in which goods have been delivered but for which not all directly related costs have been settled. If such awards are considered to be incidental costs that can be measured reliably, then recognising revenue in full upon delivery of the initial product would be appropriate under IAS 18.19. *CL51 KPMG*

20 This group of commentators favoured an Interpretation that would require the award credits to be identified as separate components only if they were regarded as separate deliverables, not incidental to the main sale. They suggested that the Interpretation could set out guidance on determining whether and when awards are incidental to the main sale, referring for example to their relative value or method of supply.

21 As with the previous group of commentators, a number of commentators in this group suggested that, if incidental awards were accounted for by accruing the expected costs at the time of the initial sale, the costs should be deducted from revenue rather than being presented as a separate marketing expense:

> In this case, we believe that customer loyalty programmes constitute a trade discount or rebate in substance. We refer to IAS 18.10, according to which award credits granted have to be accounted for as a reduction in revenue, rather than recognised as an expense. *CL29 German Institut der Wirtschaftsprüfer*

C *Advocates of cost accrual*

22 Sixteen commentators favoured a cost accrual approach for all customer loyalty programmes. Applying this approach, all revenue would be recognised at the time of the initial sale, along with a liability for the cost of providing the awards. In support of this view, the commentators argued that:

a) the substance of all, or the vast majority of, customer loyalty programmes is that of a marketing expense rather than a sale. The value of the award credits is typically very low. The customer does not see the transaction as comprising two separate sales (or, for example, value air miles on a transaction-by-transaction basis). *CL5 Malaysian Accounting Standards Board, CL20 Finnair, CL35 British Airways, CL37 HSBC, CL45 grocery retailer, CL52 UK Assoc. Chartered Certified Accountants, CL55 EFRAG.*

> The commercial reality and substance of these programmes is customer retention and encouragement to make purchases or use the services of the entity. These programmes are therefore 'marketing' in nature and represent an additional cost of promoting the product or service. For example, a credit card provider which incentivises customers to transact by granting customers award credits such as 'points' or 'air miles' is in the business of providing credit lines and not providing an air transport service. Therefore the cost of the points is an additional expense in order to promote the entity's core product, which is the credit card product. *CL37 HSBC*

b) fair values cannot always be measured reliably. Hence a revenue-deferral model would not achieve comparability. *CL13 Swiss GAAP FER, CL37 HSBC, CL41 Swedish EITF, CL55 EFRAG.*

c) the proposed revenue deferral approach would be complex to implement. It would not produce better quality or more useful information. The costs would greatly exceed the benefits. *CL2 British Bankers' Assoc., CL10 Belgacom, Debitel, Deutsche Telecom, Telefonica, Vodafone, CL12 South African Inst. Chartered Accountants, CL20 Finnair, CL22 South African Airways, CL23 European Assoc. Co-operative Banks, CL32 UBS, CL45 grocery retailer, CL55 EFRAG.*

> SAA do not have the structures and systems in place to provide them with the appropriate information to comply with the requirements of the draft interpretation, being to account for the award credits separately at the point of sale by reference to the relative fair value of the components of the sale. For example: the current loyalty software is configured to trace and allocate miles to members as and when they fly, and it does not interface with the newly implemented [financial reporting] system. Extensive system changes would be required for this purpose. This will increase the costs of compliance and yet there is little benefit for the information to the users. *CL22 South African Airways*

d) deferred revenue does not meet the definition of a liability. The balance sheet does not reflect economic reality. Reported revenue would be understated in fast-growing businesses. *CL22 South African Airways, CL45 grocery retailer.*

e) until there are principles for identifying separate components within a revenue transaction, the IFRIC should not seek to impose rules-based solutions for some transactions if the effect is to require a major change in practice for the vast majority of entities. There is a risk that the rules are not compatible with practice for other transactions. The decisions may be reversed when the IASB's revenue recognition project reaches fruition. *CL12 South African Inst. Chartered Accountants, CL55 EFRAG, CL2 British Bankers' Assoc., CL10 Belgacom, Debitel, Deutsche Telecom, Telefonica, Vodafone.*

> In our view, if the IFRIC is to address a gap in IFRS, it needs to do it in a principles-based way if it is not to find itself producing one rule-based solution after another to address slightly different circumstances. … However, D20 does not clarify a principle that might be used to determine when a transaction should be considered a separately identifiable component. … We therefore struggle to understand the reason why the IFRIC concludes that award credits are always separate components of revenue. For instance, it is not clear that there is a difference in principle between goods sold with a 'normal' warranty and goods sold with award credits. In a second example, we also struggle to understand the difference between a marketing cost and an award credit.

> … The need for a principles-based approach might be less important were D20 to be doing little more than confirming the practice that is most commonly used, but it is in fact proposing the adoption of an approach that the vast majority of those affected do not use. And it is proposing an approach that is probably more complex than the other approaches available. That does not in itself make it the wrong approach (although, we are for other reasons arguing that it *is* the wrong approach), but it does make it more important to show that the solution is conceptually sound and consistent with the way that analogous transactions are accounted for, rather than simply an ad hoc solution. *CL55 EFRAG*

f) a small minority of loyalty programmes might be more appropriately accounted for using the deferred revenue approach (eg if the awards are supplied by the entity itself and their value is very significant). However, it would take some time to develop criteria that would enable these programmes to be differentiated from other programmes. To eliminate divergence in the meantime, an expedient solution would be to apply the cost accrual approach for all programmes. *52 UK Association of Chartered Certified Accountants, CL55 EFRAG.*

No overall view

23 Of the five commentators who did not express an overall view on the approach, two, *CL24 Korea Accounting Institute* and *CL56 IOSCO* explained that their members held different views, so that no overall consensus had been reached:

> …we appreciate the level of difficulty in determining the appropriate accounting for such programmes. This difficulty has been evidenced to us by the strong differences in views held by members of the [IOSCO Standing Committee on Multinational Disclosure and Accounting]. While certain members support the consensus reached in the Draft Interpretation, other members believe that customer loyalty programmes represent marketing expenses. Still other members believe that the accounting should depend on the nature of the programme given the variety in the types of programmes offered. Accordingly, we believe it is important that the Basis for Conclusions provide as much explanation as possible for why any consensus reached results in superior financial

> reporting as compared to the alternative views. If the Draft Interpretation is adopted more or less as proposed, we would suggest that the Basis for Conclusions therefore provide a discussion of why customer loyalty programmes are not marketing expenses and would suggest that specific examples of such programmes might be helpful in providing that analysis. *CL56 IOSCO*

Staff analysis

24 The staff have considered the main arguments put forward by commentators opposed to the D20 approach and has identified a number of counterarguments as set out below.

Awards are in substance marketing expenses

25 As reported in paragraphs 17a), 19 and 22a), opponents of D20 argued that loyalty awards are in substance marketing expenses associated with the initial sale, since they are designed to obtain the first sale and do not themselves deliver substantial additional value to the customer (who may not even want the awards).

26 It is true that the value of loyalty award credits is typically not high. However, customers must attach some value to them: as CL38 *Ernst & Young* points out (paragraph 8), customers receive awards only if they actively join the loyalty programme and then claim and redeem the award credits. Sometimes customers can buy loyalty award credits for cash to help them accumulate the number needed to claim awards. Some entities even offer the customer a choice of award credits or a cash discount or rebate—customers who choose to sacrifice cash for award credits must place value on them. The fact that typically the awards are relatively low in value does not affect their substance, which is determined by their nature not their value.

27 It is also possible to counter the suggestion that *any* activity that is designed to acquire or retain a customer is necessarily a marketing expense. Such activities can include offers of cash discounts, volume rebates or major non-cash incentives,

such as free mobile phones with telecoms service contracts or rent-free periods in property leases. Each of these incentives is designed to secure the sale of other goods or services, but they are not necessarily accounted for as marketing expenses. IAS 18 *Revenue* requires cash discounts to be treated as reductions in revenue. SIC 15 *Operating Leases—Incentives* requires rent-free periods (and any other incentives) to be accounted for as reductions in rental income.

28 Incentives to customers can be distinguished in substance from marketing expenses. Marketing expenses are incurred independently of a sales transaction, to secure that transaction. Incentives to customers are part of the sales transaction itself—whether they reduce the consideration receivable or increase the goods or services deliverable, they are elements of the market exchange between the entity and its customers.

Awards are in substance volume rebates

29 Some commentators argued that the liability to provide awards should be treated in the same way as a liability to provide volume rebates—measured at expected cost and presented as a deduction from revenue (see paragraphs 16 and 21).

30 This presentation would reflect the awards as part of the sales transaction, rather than a marketing expense. However, it could be argued that it attaches the awards to the wrong leg of the exchange—the awards are part of the goods or services deliverable *to* the customer, not a reduction in the consideration received *from* the customer.

IFRIC has not established general principles for identifying separable components

31 Some commentators criticised the IFRIC for not developing general principles or criteria interpreting the meaning of 'separately identifiable components' in IAS 18. The commentators argued that without such criteria, the IFRIC could not justify its consensus that award credits were separately identifiable components to

which revenue should be allocated. (See quotes following paragraphs 19 and 22e).)

32 The IFRIC has, on a number of occasions, rejected projects that would require it to formulate general criteria for determining whether components of a sales transaction are 'separately identifiable'. There is a range of possible criteria based on, for example, whether the goods or services have separate utility to the customer, whether they can be bought and sold separately, or even are just available as optional extras. The choice of criteria would affect many types of transaction across a range of sectors. The IFRIC has concluded that it could not reach a consensus on a timely basis, and that it should not pre-empt the work that the IASB is doing on multiple-component transactions within its revenue project.

33 However, it could be argued that the IFRIC does not need to develop general criteria for identifying separate components for it to reach a consensus for customer loyalty programmes. The argument would be that whatever criteria are chosen to define separately identifiable components, loyalty awards will meet the criteria—the goods or services for which the loyalty points can be redeemed are inherently completely independent of the goods and services delivered in the initial sale. They are not even specified at the time of the initial sale.

34 Some commentators (see quotes following paragraph 19) argued that if awards were incidental to the main items sold, ie offered to elicit the main sale without providing substantial additional value, they would be linked to / associated with the main items sold. They would not be separately identifiable. A possible response to this suggestion is that, if goods or services are individually material, whether they are separately identifiable depends on their nature, not the reason for offering them as part of a sales package. Otherwise, whenever goods and services were bundled, the accounting treatment could be varied depending on whether the seller deemed any of the goods or services to have been included in the package to entice the buyer to buy the other items in the package.

There is no difference in principle between warranties and award credits

35 One commentator, *CL55 EFRAG*, questioned whether there was any difference in principle between goods sold with a normal warranty and goods sold with award credits (see quote following paragraph 22e)).

36 IAS 18 specifically refers to warranties when it describes expenses that are related to goods sold and would be recognised at the same time as the revenue from the sale of the goods. This reference implies that warranties would not be treated as separate components. However, warranties can be distinguished from award credits. Applying criteria based on separate utility to the customer, they would not be identified as separable—they are of no use except attached to the goods with which they are sold. This difference was explained in paragraph BC7(a) of D20:

> 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

Awards do not give rise to revenue if not marketed separately

37 Some commentators argued that revenue should not be allocated to awards that the entity does not market separately (such as wine glasses awarded by petrol retailers). The view focused on arguments (paragraph 17) that such awards are not part of the ordinary activities of the entity. Hence they do not generate revenue, which is defined in IAS 18 as 'income that arises in the course of ordinary activities of an entity'.

38 In response, it could be argued that the awards may not be the *main* activity of the entity, but they are supplied on a recurring basis in the course of its ordinary activities, as one (albeit small) component of its sales to customers.

39 To support this view, reference could be made to the IASB *Framework*, which, in the context of whether items arise in the course of the ordinary activities of the entity, distinguishes between recurring/usual activities and non-recurring/unusual activities.

> 72 Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way, consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.

40 An entity that supplies awards as part of a customer loyalty programme does so on a recurring basis, even if it does not market the awarded goods or services separately.

Awards do not give rise to revenue if supplied by a third party

41 Most commentators who thought that the D20 approach was appropriate for some award programmes but not others were particularly opposed to requiring it when entities engage third parties to supply awards, eg when a credit card company grants customers air miles. They supported retaining a cost accrual approach for such schemes.

42 None of these commentators acknowledged (or perhaps realised?) that, in such circumstances, the D20 approach would typically have the same accounting consequences as the cost accrual approach:

a) paragraph 8(b) of D20 would require the credit card company to recognise revenue attributed to the air miles when the obligation to supply the air transport was assumed by the airline. The assumption typically occurs as soon as the air miles are granted, ie at the time of the initial sale. Hence, the full amount of the consideration received from the initial sale would be recognised immediately. At the same time, the entity would recognise its obligation to pay the airline for the air miles, ie accrue the costs of settling the obligation.

b) whether the costs were accounted for as operating expenses (as advocated by some commentators) or as a reduction in revenue (as advocated by others—see paragraphs 16 and 21) would depend on whether the entity regarded the consideration allocated to the award credits as having been collected on its own account, or on behalf of the third party (in a capacity similar to that of agent). If the latter, the entity would apply paragraph 8 of IAS 18 and recognise revenue only for the net of the consideration allocated to the award credits and the amount payable to the third party for them. In other words, the cost of the points would be presented as a reduction in revenue. D20 does not preclude net presentation in these circumstances[3].

43 Although the D20 and cost accrual approaches lead to the same accounting treatment, they arrive at that treatment through different processes. It could be argued that the D20 process is preferable because:

a) it does not portray the requirements for third-party programmes as an exception to the general requirements. It acknowledges that, whoever

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[3] As discussed in paragraph BC14 of D20.

supplies the awards, the customer is receiving, and hence implicitly paying for, two separate goods or services;

b) it copes with customer loyalty programmes in which customers have a choice of awards, some of which are supplied by the entity itself and some of which are supplied by a third party. The consideration initially allocated to the award credits is recognised as revenue when the customer makes his or her choice and either the entity supplies the awards or the third party assumes the obligation to supply them. If the Interpretation scoped out third-party awards, or required them not to be identified as separate components, it could be difficult to determine how mixed programmes should be accounted for.

The fair values of award credits cannot be measured reliably

44 A concern of many commentators (both supporters and opponents) was that the fair values of, and hence consideration allocable to, award credits cannot be measured reliably. Commentators noted that many variables have to be estimated—such as the fair values of the range of available awards, the frequency with which each of these awards will be selected, forfeiture rates and timing of redemptions.

45 In response, it could be noted that most of these variables also have to be estimated to apply a cost accrual approach. The only difference is the need to estimate the fair value of the goods or services on offer, rather than their cost. How difficult it is to measure fair value depends on the nature of the scheme.

46 At one end of the scale are the ‘monetised’ programmes, where a specified number of points entitle the customer to a fixed discount, eg 250 points can be redeemed for $2.50 off a future grocery bill. For such schemes, the fair value of the goods or services offered is readily observable—it is the value of the

discount[4]. Indeed, fair value will typically be more reliably estimated than cost, which will have to be estimated on the basis of expected profit margins.

47 More generally, if the price at which the awards would otherwise be sold to the customer is readily obtainable, the fair value of award credits should be as easily and reliably estimated as the cost of supplying the awards.

48 As many commentators observed, the fair value of the awards becomes more difficult to estimate if the programme is 'marginally managed', ie the goods and services offered to the customers are restricted to those that would otherwise expire unused. The example frequently referred to in comment letters was restricted-use air miles. Here the fair value is clearly less than the price charged for seats with fewer restrictions. However, even for such schemes, there will be evidence available to help estimate fair values of the free flights:

a) many major airlines sell 'distressed seats' (tickets that they cannot sell through other channels) via discount ticket agencies such as Priceline.Com. The average prices achieved via these channels could be used as a reference point for the fair value of seats offered in truly marginally-managed loyalty programmes;

b) as reported by the *staff of the Canadian Accounting Standards Board (CL15)* one airline, Air Canada, now offers customers the choice of either air miles or a fare reduction. The fare reduction (or similar discounts offered by other entities) would place a lower limit on the fair value of the award credits.

c) some airlines also sell air miles to other entities, such as credit card providers. The price charged to these entities would not necessarily equal the fair value of the award credits on their own (the airline might be providing other services to the other entity which might increase the price it charges, or it might be involved in reciprocal arrangements with other

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4 Beyond that offered to customers who do not have award credits.

entities, which might reduce the prices it charges). However, the prices, and the assumptions used to set them would provide some evidence of the fair value of the air miles granted to customers.

49 Some airlines (such as United Airlines and Air Canada) already adopt a D20-type separate component approach for their award credits. They defer revenue based on the fair value of the air miles granted. Management and auditors of these airlines presumably take the view that fair value can be estimated sufficiently reliably.

The costs exceed the benefits

50 As many commentators pointed out (for example in paragraph 13), D20 would impose costs on entities. There would be implementation costs arising from the need to install new accounting processes and systems. There would be ongoing costs of applying a more complex accounting treatment. Several commentators argued that there were not demonstrable benefits to justify imposing additional costs.

51 In response it could be argued that the benefits would arise from improving the comparability of financial statements and relevance of the measurement of customer loyalty programme obligations:

a) all entities would measure their customer loyalty award obligations on the same basis, enabling more meaningful comparisons of their results and financial positions.

b) entities, such as airlines, that both grant award credits to their own customers and sell them to other entities would measure the two identical obligations on the same basis. At present, a number of airlines applying IFRSs defer revenue received for ‘sold’ air miles but accrue costs for air miles granted to their own customers.

c) more generally, entities would measure their customer loyalty performance obligations on the same basis as any other performance

obligations to customers, ie at the consideration the entity had received to perform the obligations.

Exceptions when assumptions make fair values unreliable

52 Some commentators suggested permitting an alternative approach (cost accrual) for circumstances in which significant assumptions reduce the reliability of revenue allocations, and the award credits are relatively insignificant elements of the overall transactions (see paragraphs 9a) and 12).

53 Such an exemption could be difficult to contain. Many entities could put up a case that significant assumptions would reduce the reliability of their fair value estimates. They would have an incentive to make such a case if the consequence was that they reported smaller liabilities. The result could be even more divergence in practice than there is at present.

54 US EITF Abstract 00-14 *Accounting for Certain Sales Incentives* addresses circumstances in which future rebates cannot be reasonably and reliably estimated. It requires the liability or deferred revenue to be recognised for the maximum potential amount, ie making no reduction for forfeitures. If the IFRIC were to offer an alternative approach, one based on recognising the maximum liability might be less susceptible to excessive use.

55 However, against *any* alternative approach, it could be argued that a roughly right measurement is more relevant than an accurately wrong one. Further, if the awards are relatively insignificant elements of the overall transactions, variations in their measurement should not cause substantial loss of comparability.

Emphasise applicability only to material items

56 As noted in paragraph 9c) supporters of D20 suggested that it be made clear that the Interpretation need not be applied to immaterial items, and that award credits might be less valuable than they appear at first sight (eg because of restrictive conditions attaching to their use).

57 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines the term 'material' and states that IFRSs need not be applied if the effect of applying them is immaterial. The IASB and IFRIC avoid referring to this exemption in each individual Standard or Interpretation—to explicitly refer to it in one pronouncement might imply that materiality is less applicable in others.

58 However, it could be argued that this Interpretation is a special case. It proposes relatively complex accounting requirements for transactions that are often immaterial. Further, their immateriality might often not be recognised because the schemes are designed to provide high-profile benefits that may appear more valuable than they actually are.

59 It may be appropriate for the IFRIC to state explicitly that, like any other Standard or Interpretation, D20 need not be applied if the effect of applying it is not material. This statement could be made in the Basis for Conclusions, in response to arguments that the approach is unreasonably complex for programmes in which the value of the awards is insignificant.

Staff conclusions and recommendations

60 In the light of the comments received, the IFRIC could proceed in five ways. It could:

a) retain the proposed approach and proceed towards a final Interpretation;

b) retain the proposed approach, but exclude some programmes from the scope of the final Interpretation, eg those that offer customers goods and awards that are supplied by third parties;

c) change the Interpretation to require the proposed separate component approach for some programmes but a cost accrual approach for others;

d) change the Interpretation to require a cost accrual approach for all programmes; or

e) abandon the project completely.

61 One member of the staff team recommends option (c). [Rest of paragraph omitted from observer note.]

62 However, the other staff members favour option (a), ie to retain the proposed separate component approach for all customer loyalty programmes and proceed towards a final Interpretation based on that approach. [Rest of paragraph omitted from observer note.]:

63 If the IFRIC supports option (a) and decides to proceed towards a final Interpretation based on the proposed approach, it could take steps to address some of the opponents' concerns. These steps could include:

a) expanding the Basis for Conclusions to explain more fully the reasons for requiring the separate component approach. Paragraphs BC5 and BC7 of the Basis for Conclusions accompanying D20 summarised some of the arguments included in the staff analysis above. However, it referred to them only very briefly. And it did not discuss at all the cost/benefit and reliability of measurement concerns raised by many respondents. The

IFRIC could add to the Basis for Conclusions some of the arguments set out in paragraphs 44-51 above and a reference to the fact that the Interpretation need not be applied if the effects of applying it are immaterial.

b) reviewing the proposed requirements regarding the measurement of fair value and recognition of revenue to identify any opportunities to simplify them. This option would be considered at a future meeting..

c) adding transitional arrangements or delaying the effective date to give entities more time to develop the necessary accounting processes and systems. This option would be discussed in more detail at a future meeting.

Questions for IFRIC members

64 IFRIC members will be asked whether they agree with the majority staff recommendation that the IFRIC should proceed towards a final Interpretation based on the approach proposed in D20 without limiting the scope (option (a) in paragraph 60).

65 If they support the majority staff recommendation, IFRIC members will be asked whether they agree that the Basis for Conclusions should be expanded to address cost/benefit and reliability of measurement concerns, referring to the arguments in paragraphs 44-51 and materiality considerations.

66 They will also be asked whether they think that any other aspects of the rationale for the proposed approach (eg as set out in paragraphs 25-43) need to be explained more fully in the Basis for Conclusions.

PAPER 3(ii) — SCOPE OF DRAFT INTERPRETATION

Comments

1. Out of 57 respondents, 25 specifically commented on the scope of the interpretation.

2. A common theme in many of the comments on scope was that some award credits should be treated as marketing expenses under paragraph 19 of IAS 18 *Revenue,* rather than as deferred income under paragraph 13, as proposed by D20. They should therefore be excluded from the scope of D20. Reasons given were sometimes conceptual and sometimes pragmatic (on the grounds of immateriality of the amounts involved). Since this issue lies at the heart of D20, it is addressed in paper 3(i) and mentioned only briefly in this paper.

3. Comments on scope fell into two main categories:

The scope is dealing with a specific arrangement, not with clearly identified principles

4. The following issues were raised :

   a. because the Interpretation deals with a specific arrangement without clearly identifying the underlying concept, there is a risk that the conclusion for the arrangements may be inconsistent with solutions for other similar arrangements. According to *EFRAG (CL55),* this is notably the case in the definition of multiple sale arrangements in service concession arrangements:

      > … the recently approved Interpretation on Service Concession Arrangements refers to separate elements and states that "… its terms call for separate elements because each separate phase or element has its own distinct skills, requirements and risks".

   b. there is a risk that what is prescribed for a specific economic arrangement might be unreasonably applied to other arrangements.
      CL33 PricewaterhouseCoopers provides the example of gift vouchers sold or

prepaid phone contracts. In PwC's view, applying what is prescribed by D20 for forfeitures to prepaid phone cards or vouchers sold would lead to up-front revenue recognition in those two cases.

The economic arrangement is not correctly covered by the scope of the interpretation

5. The following issues were raised:

   a. some arrangements which are common features of customer loyalty programmes would technically be excluded from the scope of the Interpretation: awards for cash rewards, points granted to customers without being directly linked to a sale or past patronage (welcome points, birthday points, etc.),

   b. the scope is too far encompassing. Some items are included in the scope that should not be:

      i. awards for goods and services that are not separately sold by the company should be excluded from the scope of the interpretation *(CL26 UNICE, CL14 ACTEO).*

      ii. marketing expenses should be scoped out. Examples of awards that should be treated as marketing expenses are provided by *CL31 Deloitte* : - when the amount granted is not significant, - when the customer does not know that he has entered a customer loyalty programme. In that last case, it cannot be considered that the customer has bought two separate items, as he is not aware of the existence of the programme.

      iii. the scope should be limited to business to customer arrangements. Business to business arrangements correspond to another economic logic and should be scoped out.

      iv. grants for items the value of which is immaterial should be excluded.

   c. the scope only covers parts of the economic arrangement:

i. when the award is provided by a third party, the Interpretation should specify the accounting for that third party.

ii. this is notably the case when multiple companies participate in a programme where the awards are provided by a third party, which in turn grants rewards that it purchases from the participating companies (for example, the UK programme NECTAR) – the accounting treatment required for all the participating parties, companies that participate in the programme as well the organiser, should be specified.

iii. points are sometimes sold between companies. The accounting treatment for such points sold should be specified.

Staff analysis

The scope deals with a specific arrangement, not with clearly identified principles

6. The concern of some respondents is that, because the Interpretation addresses how to account for a specific transaction, it might contradict principles that have been applied to similar conceptual issues when dealing with other arrangements. As an example, the criteria applied for defining separable elements of a transaction in service concessions appear to be different from the ones that are currently considered in the Exposure Draft.

7. In response to this concern, it could be argued that:

   a. there is a large diversity in the nature of the economic arrangements that lead to the recognition of revenue. The fact that different criteria are used to come up with solutions for revenue recognition issues that fall under the same heading may simply reflect the diversity of the economic arrangements. For example, the service concession referred to in the comment letter is of a very different nature to the customer loyalty programmes dealt with in the draft Interpretation.

b. it has not been possible as yet to identify principles that work in every instance.

c. therefore the fact that different criteria are used to deal with the identification of different economic situations is not critical per se. It would not be the case however if the criteria were in contradiction with each other. It is not the case.

8. Some respondents fear that there is a risk that what is prescribed for customer loyalty programmes may be unreasonably extended to other economic arrangements. This is notably the case for the method selected for taking into account forfeiture rates at the origination of the sale to evaluate the fair value of the rights granted.

9. In response to this concern it could be argued that:

a. the example provided by the respondent (pre-paid phone cards) is a valid one.

b. however, the staff believes that the proposed method for taking into account forfeiture would not lead to up front revenue recognition for pre-paid phone cards or gift certificates. D20 would require the revenue attributed to the phone cards or gift certificates to be based on (an allocation of) the proceeds received, not the fair value of the goods delivered. It would then require the revenue to be recognised over the period in which the cards were used or redeemed. Revenue attributed to rights that were expected to be forfeited would be recognised over this period, not at the inception of the sale.

c. there is no guidance on the accounting for forfeiture rates within IFRSs. Therefore, were the rules for customer loyalty programmes applied to pre-paid phone cards, it would not be in contradiction with IFRSs; besides, the staff believes at this stage that those rules are consistent with the current practice.

d. in any case, the proposed accounting treatment for forfeiture in the proposed Interpretation has been challenged and will be reviewed.

10. Therefore, the staff recommends that :

    a. No amendment be made to the scope, as it does not appear that the principles selected for dealing with customer loyalty programmes may contradict any principles selected for other arrangements

    b. The specific comments on forfeitures be reconsidered when the IFRIC addresses forfeitures later in the project.

The economic arrangement is not correctly covered by the scope of the interpretation

11. The staff thinks that the arrangements described in paragraph 5a should be included in the scope of the draft Interpretation. The staff thinks that those arrangements are within the scope as it is currently drafted :

    a. *awards for cash rewards:* when the customer receives a cash reward after a number of purchases, it is in fact as if he had received a discount on the price of his final purchase. This device is therefore within the scope of the Interpretation. If the customer is entitled to a cash reward immediately after his first purchase, then the economic nature of the arrangement is that of a rebate, which is clearly scoped out of the Interpretation;

    b. *welcome and birthday gifts:* paragraph 2 of the Interpretation indicates that the grant of points may be linked to individual purchases or a group of purchases. In the case of welcome points and birthday points, the grant can be linked to a group of such purchases.

12. As indicated in paragraph 2 of D20, the programmes operate in a variety of ways. It is not possible, nor advisable, to give a list of all possible arrangements that may be created that would fall under the scope of customer loyalty programmes. Preparers and auditors will have to use their judgement in order to evaluate if the arrangements fall under the scope of D20 or not. However, the IFRIC may consider including a series of examples of the most common features of the programmes in the Interpretation, in order to give guidance to help evaluate if the arrangements should be in the scope of the Interpretation or not.

13. As addressed in paper 3(i), some commentators consider that some arrangements should be scoped out: two types of rationale are put forward:

    a. the economic nature of the arrangement is not that of a customer loyalty programme, but rather of a marketing expense or of some other undetermined nature (business to business arrangements),

    b. the expenses that would arise from accounting for the CLPs would be immaterial.

The economic nature of the arrangement is not that of CLP

14. This is probably the rationale that is the most referred to in the comment letters that consider that the Interpretation fails to address correctly the accounting for CLPs.

15. Because the rationale put forward by the respondents to justify these scope exclusions refers to issues that are dealt with in paper 3(i), they are not further addressed in this paper.

16. However, the staff wishes to address the following issue : if the IFRIC favours a mixed approach with regard to defining customer loyalty programmes as multiple sale arrangements, would scoping out some of the programmes because, say, the goods or services granted are incidental or provided by third parties, be an adequate way of dealing with the issue?

17. With regard to this, the staff notes the large variety of respondents that consider that, for one reason or the other, their arrangements do not meet the characteristics of CLPs. In particular, because of the measurement uncertainties, the materiality argument is used for justifying the scope exclusion of arrangements with very diverse characteristics.

18. Therefore, the staff recommends having all customer loyalty programmes included in the scope. If some programmes do not meet the criteria for multiple elements sales, it should be clearly stated in the Interpretation which programmes do, and which programmes do not. Not doing so would create a risk of diversity in practice.

Non materiality issues

19. The Staff thinks that the same rationale applies to non materiality issues, as dealt with in the preceding paragraphs.

The Interpretation does not cover the scheme entirely

20. The staff considered the suggestions that the Interpretation does not adequately cover the economic nature of the arrangements, because it does not explicitly deal with the accounting of the third party to the arrangement. This is notably the case when the customer loyalty programme is an arrangement involving multiple companies, an operator of the programme, and where customers have access, via the operator, to goods and services provided by any of the companies participating in the programme.

21. On this issue, the staff considers that the main goal of the proposed Interpretation is to determine when CLPs are to be considered as multiple elements sale arrangements. The wording of the consensus currently adequately covers this issue, and the staff does not favour at this stage including in the Interpretation guidance on an issue – the third party accounting - that does not belong to the core of the issue dealt with by the Interpretation.

22. Besides, none of the comment letters has identified a concrete issue with regard to the accounting of the third party. (The only issue raised relates to paragraph 9 of the Interpretation, when a company participates in a programme involving multiple companies and an external operator. When should it be considered that a company has transferred its obligation to a third party when it participates in such a programme?)

23. Having considered all the above, the staff considers that there is no need to amend the scope to address third party accounting. The IFRIC might however in due course consider providing extra guidance on how to apply paragraph 9 of the Interpretation to arrangements involving multiple companies and an operator for the loyalty programme. This would be considered at a future meeting.

Points sold

Some commentators have called for more guidance on how to account for points sold to customers, instead of being granted through a customer loyalty programme.

Here again the staff considers that the main objective of the Interpretation is to determine if customer loyalty programmes are multiple sale arrangements, and how to account for them when it has been determined that they are. How to account for points sold should not be part of that Interpretation and preparers and auditors will have to apply existing literature, as well as their judgement when determining the accounting for such points.