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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**20 June 2007, London**
Project:	**IFRIC X *Customer Loyalty Programmes***
Subject:	**Request for ratification of Interpretation (Agenda papers 7A and 7B)**

Paper 7A asks the Board to ratify an Interpretation for entities that grant loyalty award credits to their customers.

1 The IFRIC has reached a consensus on how entities should apply IAS 18 *Revenue* if they grant loyalty award credits (air miles, points etc.) to customers who buy other goods or services.

2 The IFRIC voted to confirm the consensus at its May meeting. The IFRIC now submits the Interpretation [Paper 7B, which has been omitted from the observer note] to the Board for ratification.

3 The IFRIC wishes to acknowledge the considerable staff support it has received on this project from Jérôme Chevy, *Chargé de Mission - International Affairs* of the Conseil National de la Comptabilité in France.

The Interpretation would require customer loyalty award credits to be accounted for as a separate component of the sale with which they are granted.

4 The main issue addressed in the Interpretation is whether:

a) *customer loyalty award credits are a separately identifiable component of the sale with which they are granted.* If so, applying paragraph 13 of IAS 18, some of the consideration received or receivable from that sale would be allocated to the award credits and recognised as revenue when the entity fulfilled its obligations to deliver awards;

or

b) *customer loyalty award credits are a cost of selling the other goods or services delivered in the sale.* If so, no consideration would be allocated to the award credits. However, applying paragraph 19 of IAS 18, the future costs of supplying awards would be accrued when revenue was recognised for the delivery of the other goods or services.

5 The consensus supports approach (a), the 'separate component' approach. The rationale, as explained in the Interpretation, is that:

> … 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 transaction 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 meet warranty claims. In the IFRIC's view, loyalty awards are not costs that directly relate to the goods or services already delivered—rather, they are separate goods or services delivered at a later date.

Constituents were divided in their views on the draft Interpretation.

6 A draft of the Interpretation was published for comment as D20 *Customer Loyalty Programmes*. Commentators fell into three broad groups.

7 The first group, which supported the consensus, included most of the large accounting firms and accountancy bodies, some national standard setters, but very few preparers of accounts.

8 The second group, mainly preparers of accounts and some national standard setters, opposed the consensus for <u>all</u> customer loyalty award programmes. They argued that a cost accrual approach was preferable because:

- it better reflected their view of award credits as marketing expenses; and
- it was simpler and more reliable.

9 The third group, again mainly preparers and some national standard setters, thought that the accounting treatment should depend on the nature of the loyalty programme. Most of these commentators accepted that the separate component approach was appropriate if the entity supplied the awards itself and if the value of the awards were significant relative to the value of the other goods or services sold. However, they did not regard the approach as appropriate for loyalty programmes in which a third party supplied the awards and/or the value of the awards was insignificant relative to the other goods or services. They argued that the supply of awards by a third party was not a revenue-generating activity for the entity itself.

10 It is possible that some of the commentators in the third group did not realise that if a third party assumed all obligations to supply awards from the outset, the separate component approach would lead to the same liability being recognised as a cost accrual approach: the consideration allocated to the award credits would be recognised as revenue immediately and the only liability recognised would be any amount still payable to the third party for supplying the awards.

In re-deliberations, the IFRIC has confirmed its consensus but taken steps to respond to constituent concerns.

11 The IFRIC was not persuaded by the arguments put forward by opponents of the draft consensus. Therefore it has retained the consensus broadly as proposed in D20. However, it has made a number of changes to the draft Interpretation to address constituent concerns. In particular, it has:

a) expanded the Basis for Conclusions to explain the difference between award credits and marketing expenses:

> Award credits granted to a customer as a result of a sales transaction are an element of the transaction itself, ie the market exchange of economic benefits between the entity and the customer. They represent rights granted to the 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 the sales transaction. Marketing expenses, in contrast, are incurred independently of the sales transactions they are designed to secure.

b) added text to the Basis for Conclusions to acknowledge and address cost/benefit considerations.

c) added ‘Illustrative Example 2’ to clarify the consequences of a third party being responsible for supplying the awards. The facts of this example are such that all revenue is recognised at the time of the initial sale, with the amount payable to the third party being accrued at the same time.

d) set a later than usual effective date for the Interpretation, to give entities that will have to change their accounting policies more time to undertake systems changes. The IFRIC has proposed that the Interpretation should be effective for accounting periods beginning on or after 1 January 2008.

In response to other requests from commentators, the IFRIC has also added more guidance on how to apply the separate component approach.

12 The IFRIC has added Illustrative Example 1 to clarify:

a) when revenue should be recognised for consideration allocated to award credits that are never redeemed; and

b) how entities should account for changes in estimates of redemption rates.

13 The IFRIC has also expanded the consensus to address in more detail awards supplied by third parties. The consensus now explicitly highlights the need for the entity to consider whether it has collected consideration on behalf of the third party (ie as an agent for the third party) or on its own account (ie as the principal in the transaction). It explains the different consequences for revenue measurement and recognition. These consequences had been discussed in the Basis for Conclusions accompanying D20. Commentators had suggested that they should be made more explicit in the consensus itself.

The Board members will be asked

1 Whether they have any questions about, or comments on, the Interpretation.

2 Whether they are in favour of ratifying it.