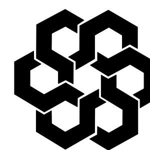

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International Accounting Standards Board

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:	**March 2007, London**
Project:	**IAS 18 Customer loyalty programmes (Agenda Papers 2 – 2(v))**

PAPER 2—OVERVIEW OF PAPERS

Introduction

1 D20 *Customer Loyalty Programmes* addresses 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 addresses 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.

2 It proposes that the award credits should be treated as a separate component of the sale in which they are granted. Revenue should be allocated to the awards only

when the entity has fulfilled its obligations in respect of the award credits, either by exchanging them for further goods or services or engaging a third party to do so.

3 At its last meeting, the IFRIC considered comments on the overall scope of, and accounting approach proposed by D20. It decided to proceed towards a final Interpretation based on the D20 approach, but asked staff to make a number of amendments to the draft Interpretation to address some of the comments received.

Purpose of this meeting

4 The purpose of this meeting is to:

- consider other comments received on D20;
- decide whether to include illustrative examples in the Interpretation and, if so, approve their content; and
- approve the drafting of changes requested at the last meeting.

5 The papers in which these matters are considered are:

Paper 2(i) Method of allocating consideration to award credits

Paper 2(ii) Revenue recognition requirements

Paper 2(iii) Awards supplied by third parties

Paper 2(iv) Other comments

Paper 2(v) Changes requested at last meeting

Paper 2(vi) Revised draft Interpretation [OMITTED FROM OBSERVER NOTE].

PAPER 2(i)—ALLOCATION OF CONSIDERATION

6 Paper 2(i) analyses comments received on the proposal in D20 on the allocation of revenue between the multiple components of sales involving customer loyalty programmes.

7 The purpose of the paper is to help the IFRIC decide whether to retain the method proposed in D20, amend it or replace it with a different proposal.

D20 proposal

8 D20 proposed that:

> 6 The allocation shall be made by reference to the relative fair values of the components, ie the amounts for which each component could be sold separately.
>
> 7 The fair value of the award credits may be estimated by reference to the discount that the customer would obtain when redeeming the award credits for goods or services. The nominal value of this discount would be reduced to take into account :
>
> a) any discount that would be offered to customers who have not earned award credits from the initial sale;
>
> b) the proportion of award credits that are expected to be forfeited by customers; and
>
> c) the time value of money.
>
> If customers can choose from a range of different awards, the fair value of the award credits will reflect the fair values of the range of available discounts, weighted in proportion to the frequency with which each is expected to be selected.

9 Paragraphs BC8, 9 and 10 explained the allocation method proposals:

> BC8 IAS 18 requires revenue to be measured at the fair value of the consideration received or receivable. Hence the amount of revenue attributed to award credits should be the fair value of the consideration received for them. The IFRIC noted that this amount is often not directly observable because the award credits are granted as part of a larger sale. In such circumstances, it must be estimated by allocating the total consideration between the award credits and other goods and services sold, using an appropriate allocation method.
>
> BC9 IAS 18 does not prescribe an allocation method for multiple component sales. However, its overall measurement objective is to determine the amount the customer is paying for each component, which may be estimated by drawing on the entity's experience of transactions with similar customers. Hence, the draft interpretation proposes that the consideration received for sales incorporating award credits should be allocated between the components by reference to their relative fair values. The IFRIC concluded that this method satisfied the overall measurement objective of IAS 18.
>
> BC 10 Paragraph 7 of the consensus includes guidance on how the fair value of award credits *may* be estimated, ie by reference to the discount that the customer would obtain when redeeming the award credits for goods or services. However, the IFRIC recognises that, in some circumstances, other estimation techniques may be available. For example, if the entity engages a third party to supply awards and pays the third party for each award credit it grants, it could estimate the fair value of the award credits by reference to the amount it pays the third party, adding a reasonable profit margin. Judgement is required to select and apply the technique that satisfies the requirements of paragraph 6 of the Consensus and is most appropriate in the circumstances. Hence the draft interpretation dos not impose any specific technique.

10 [Paragraph omitted from observer note.]

Comments (A) The IFRIC should not impose a specific method for the allocation of revenue

Analysis of the comment letters

11 Seven letters commented on the fact that D20 was imposing a specific method for allocating revenue between the two components of the sale, this allocation being based on the relative fair values of the two components. One (PwC) supported the proposed approach, while the others expressed concerns (5) or disagreement (1 – *CL43 German Accounting Interpretations Committee).*

12 The concerns expressed can be grouped as follows :

a) the IFRIC is going beyond what it is entitled to do by imposing a method that is not compulsory in IAS 18. For one commentator this is being done without clearly explaining why this specific method has been proposed:

> We disagree with paragraph 6 of the Draft Interpretation, which requires the fair value of the consideration received to be allocated to the separately identifiable components of the transaction based on those components' relative fair value. The fundamental revenue recognition principle in IAS 18 is stated in paragraph 9 which requires that "revenue shall be measured at the fair value of the consideration received or receivable". Further paragraph 13 of IAS 18 states that the criteria in IAS 18 paragraph 9 should be applied to the separately identifiable components of a transaction when this is necessary to reflect the substance of the transaction. The standard is silent on how this should be done.
>
> D 20 paragraph 6 appears to prescribe explicitly one method for the allocation of the fair value received or receivable to the separately identifiable components of the transaction – on a relative fair value basis ie the amount for which the components could be sold separately. As IAS 18 does not currently prescribe this method we do not think the IFRIC has justified its decision to restrict the allocation method as it appears to have done. *Deloitte*

b) There is a risk that the requirements for customer loyalty programmes may be extended to other arrangements, while, at the same time, the examples cited in IAS 18 seem to indicate that other methods might be used:

> We believe that there is conceptual merit to allocating the consideration received by reference of the relative fair values of the components as this is consistent with the measurement objective of IAS 18 Revenue. However, we believe that other methodologies may be consistent with IAS 18, as IAS 18 does not clearly address allocation between components and it is not clear that certain examples provided in the Appendix that accompanies IAS 18 always result in an allocation that is based on relative fair values. *IOSCO*

c) Other methods might produce more relevant results than those of the relative fair values.

> Taking this into account those members of the AIC in favour of a fair value approach argue that the allocation using a residual approach would lead to more appropriate results than the reference to the relative fair value approach proposed by the IFRIC. *Rechnungslegung Interpretation Committee*

Staff analysis

13 Some respondents considered that the IFRIC was issuing guidance beyond what it was permitted to do, as it was requiring a specific method for allocating the consideration received by the company that is not the only method permissible by IAS 18. However, it can be argued that it is within IFRIC's remit, when there is diversity, to reduce that diversity by requiring one specific method to be applied, or other methods to be forbidden.

14 Other commentators considered that whilst the IFRIC was acting within its remit in requiring a specific method, it had not conceptually justified its choice. But it can be argued that paragraphs 8, 9 and 10 of the Basis for Conclusions of the proposed Interpretation clearly explain the rationale for the IFRIC decision, notably the fact that, according to IAS 18, the revenue booked by a company shall correspond to the amount of the consideration received by the company in

exchange for the transaction. This rules out any method of allocation that would not be based on the fair value of the consideration received.

15 According to some of the commentators however, if the case for the use of fair values has clearly been made, this is not so for the use of a <u>relative</u> fair value method, instead of other allocation methods based on fair values. An example of such other method could be the residual fair value method, by which the fair value of one of the component of the sale is wholly allocated to that component, the other part of the allocation being based on the residual.

16 One of the arguments in favour of that method is that at least the revenue of one part of the sale is not distorted. Also, some of the examples in the appendix to IAS 18 seem to be based on such a residual method, notably example 11 "Servicing fees included in the price of the product". It could be argued however, because of the way the current IAS 18 is drafted, that the example 11 deals with the method of evaluating the fair value of an element of the sale in the absence of market prices (see below), not how to allocate the fair value received in a transaction in case of a multiple component sale.

17 In favour of retaining the relative fair value proposals, it could be argued that relative fair values provide a better economic representation of the fair value of the consideration received from the customer, by fairly allocating the total proceeds of the sale between its two components.

Staff recommendation

18 The have identified three possible ways of proceeding:

a) not to refer at all to how the total fair value of the consideration received for the goods and services received should be allocated. In other words, the current paragraphs 6 and 7 would not be part of the Interpretation, which would simply state that customer loyalty programmes should be

considered as multiple element arrangements, and the consideration allocated between the components;

b) specify that the allocation should be made by reference to the fair value of the goods and services granted, without specifying any further if the allocation should be made using a *relative* fair value approach, or a *residual* fair value approach;

c) retain the current proposal.

19 The staff will not recommend option (a). [Rest of paragraph omitted from observer note.]

20 Having considered the comment letters, there is some support within the staff for option (b), ie to continue to require the consideration to be allocated by reference to the fair value of the award credits, but not to specify *relative* fair values. [Rest of paragraph omitted from observer note.]

21 However, the balance of the staff view is in favour of option (c), ie retaining the requirement to allocate revenue on the basis of relative fair values. [Rest of paragraph omitted from observer note.]

22 Therefore, the staff will recommend option (c), that is, to retain the current proposal of the draft interpretation for consideration to be allocated by reference to relative fair values.

Question for the IFRIC

23 IFRIC members will be asked whether they agree with the staff recommendation.

Comments (B) Fair value is not reliable

Comments

24 One of the main concerns of the commentators with regard to the requirement to measure fair value is that the fair value of the rights granted will not be reliably measurable:

a) there will not be any market price available in many cases:

> In some cases, there are no willing buyers for the goods and services granted in the frame of the customer loyalty programmes. This is the case when an airline company offers seats that would otherwise be vacant. Thus the fair value cannot be measured on a reliable basis, all the more since the price setting can result in very different prices depending on when the flight is made. In such situations we believe the deferred revenue should be measured by reference to the marginal cost of the goods or services provided. *Mazars*

b) The programmes allow customers to choose between a wide range of goods and services; therefore, evaluating the fair value of the goods and services granted as awards requires using non reliable estimates.

c) evaluating the fair value of the rights requires historical information about, notably redemption rates. There might be no such information available, notably when the programme has just been launched.

25 Those commentators call for methods other than fair value to be used in allocating value to the separate components of the sale. Other methods proposed by those commentators are:

a) future costs that will be incurred to provide awards;

b) cost plus reasonable margin; and

c) incremental costs.

Staff analysis

26 [Paragraphs 26-31 omitted from observer note]:

Staff conclusion

32 The staff acknowledges that, on some instances, there might not be a readily observable market price available for the goods and services granted as rewards for loyalty customer programmes that may help evaluate the fair value of the rights granted to customers as part as these programmes. In such cases, companies and auditors will have to use their judgements to select the appropriate method for evaluating the fair value of the rights. The next section will consider if more guidance is necessary to help companies determine the fair value of the rights.

Question for the IFRIC members

33 IFRIC members will be asked whether they agree with the staff conclusion that the fact that there will be cases where no market price will readily be observable for the goods and services granted within loyalty programmes does not justify the use of alternative methods not based on the fair value of the rights.

Comments (C) Question proposed guidance

Comments

34 Some commentators questioned the guidance that was provided on how to measure the fair value of the award credits.

Relating to the concepts and definition of fair value provided in the Interpretation.

35 Some commentators questioned the definition of fair value which is underlying the guidance proposed in D20. Some also called for specific guidance regarding the definition used in the Interpretation. The various comments received on that matter can be grouped as follows :

a) the Interpretation is putting forward a definition that favours a "customer perspective", not a company perspective :

> Paragraph 7 indicates that "the fair value of the award credits may be estimated by reference to the discount that the customer would obtain when redeeming the award credits for goods or services". This seems to suggest that deferred revenue should be measured from the perspective of the customer. Yet we read paragraph 6 as referring to measurement from the perspective of the entity. We note that other standards – for example IAS 18 and IFRS 2 – adopt an entity perspective. *CL 55 EFRAG*

b) because of the uncertainty that surrounds the definition of fair value used in the Interpretation, practical concerns arise : for example, it should be clearly stated in the standard that the company own price list should be allowed as a reference for evaluating the fair value of the rights granted:

> Many constituents, who have understood "fair value" as market value and possibly different to the entity's own tariffs, consider it would be impracticable to apply such a valuation basis, ie a "market value" for which the entity would have to maintain benchmarking information. Further more, it is argued that the liability is a component of specific sales transactions of an entity (entity specific) and a different market valuation would not be relevant.
>
> We believe that the entity's tariffs represent market value and should be applied when the information is available.
>
> We suggest that the Interpretation should clarify that it considers that an entity's tariffs normally represent fair value." *Conseil national de la comptabilite.*

c) One respondent took a very different view, arguing that no guidance should be given on how to measure fair values:

> "Our greatest discomfort with D 20 however is its total disregard for achieving principle based solution. … Why is a page and a half necessary to state the simple fact that award credits should be accounted for as separately identifiable components of the sale transaction in which they are granted? The rest of the paragraphs 5 to 11 could much better be consigned to illustrative examples or simply dropped where statement of the consensus is sufficient for entities to know how they have to proceed. *Swiss holdings*

Comments on the proposed guidance

36 Three major categories of comments have been made with regard to the guidance proposed in the draft Interpretation :

a) Some commentators consider that the amount of guidance provided in the draft is not sufficient. As opposed to some commentators quoted before, they request more guidance than was provided in the draft,

b) Discounting is a concern that has been put forward by many commentators,

c) a third category consider that the expected forfeiture rate should not be part of the fair value calculation of the rights but instead should be taken into account when deciding which amount of revenue to recognise.

37 Some commentators consider that the level of guidance provided in the draft is inadequate. Their request is either for more guidance in general :

> This is a complex accounting procedure considering that the fair value of the rights has to be estimated. Swiss GAAP FER thinks that the guidance provided in paragraph 6 of D 20 is not sufficient" *Swiss GAAP FER*

or on a specific issue. Among requests are:

a) guidance for programmes run by airline companies, notably when the range of prices for available seats is wide

> … for example, it is a known fact that airline companies operate a differential pricing policy when making seats available in return for air miles. We suggest that the interpretation should specifically address the application of the relative fair value approach in such a situation." *UK 100 group*

b) guidance when the awards are for free goods and services, not discounts:

> Paragraph 7 only discusses that the fair value of the awards may be estimated by reference to the discount that the customer will obtain when redeeming the award. The draft interpretation only addresses using the award to obtain a service or a product at a discount and not situations where the customer uses its award to obtain a product for free, where the discount would then be 100%. Could the IFRIC please provide more guidance on this matter?" *FirstRand Banking Group*

c) guidance for actuarial methods to be used when evaluating the choice the customer will make between the range of goods and services that are offered to him.

d) guidance on whether the use of business plans is permitted when evaluating the value of the rights and services.

Discounting

38 Six comment letters made reference to the discounting that is referred to in paragraph 7. Two of the commentators ask for simplification (no unwinding of the discount, no discount for rights that would be redeemed within the next year), one asked for more guidance. Three commentators argued that the evaluation of the rights should not involve discounting for the time value of the rights. The reasons put forward by those commentators were :

a) the rights are not financial instruments,

b) if the measurement were to involve discounting for the time value of the rights, then criteria such as the effect of inflation should be taken into account:

> Paragraph 7 of the Draft interpretation stated that in determining the allocation of revenue, the time value of money should be taken into consideration. As deferred revenue is not a liability or a provision, we do not understand why this is suggested. If the IFRIC proceeds with this principle, it should clearly state why this appropriate and whether this principle should be applied more widely. SAICA

Forfeiture rate

39 Finally, one commentator recommended that the expected forfeiture rate should not be taken into account when estimating the fair value of the rights, but when deciding what amount of revenue to recognise. This would lead to a system close to the one of IFRS2:

> We do not believe it is appropriate to reduce the fair value of the discount to take into account the proportion of awards credits that are expected to be forfeited by customers. We believe that expected forfeiture should be taken into account as a reduction of the amount of deferred revenue after it has been determined using the relative fair value approach. At each balance sheet date, the carrying amount of revenue should be reviewed having regard to the experience of the proportion of award credits that have been redeemed and actual forfeitures. Adjustments to the carrying amount of deferred revenue should be included within revenue. We believe that this approach would be analogous to the accounting for expected and actual forfeitures specified by IFRS 2. *UK 100 Group*

Staff analysis and recommendations

40 [Paragraph omitted from observer note.]

More or less guidance

41 One of the major concerns of some respondents to the Exposure Draft was the level of guidance provided for the measurement of the fair value of the rights. Currently the Draft Interpretation provides guidance in its paragraph 7.

42 [Paragaphs 37-39 omitted from observer note.]

40 Three possibilities could therefore be envisaged for proceeding with the Interpretation :

a) extend the level of guidance, so that it covers the various cases and circumstances that have been considered in the comment letters, as well as better explain the rationale for the choices that have been made in the example,

b) amend the guidance, either its content or its format,

c) delete paragraph 7 and not provide any specific guidance on how to estimate the fair value of the rights.

Staff recommendation

41 [Paragaphs 41-44 omitted from observer note.]

45 The staff recommendation will be to keep the guidance currently in paragraph 7, but perhaps move it in the Interpretation to a separate section containing Implementation Guidance. Also, the staff recommends making it clear that other techniques would have to be implemented if the facts and circumstances were different—in other words, moving some of the text from BC10 of D20 (see paragraph 9 above) into the implementation guidance.

Questions for the IFRIC

46 IFRIC members will be asked whether they agree with the staff recommendations that:

a) the guidance in paragraph 7 should be retained,

b) it should be moved to a separate section for Implementation guidance, and

c) additional guidance explaining that other methods may be used should be added, eg by moving text from BC10 of D20.

47 If not, they will be asked which alternative they would favour.

Discounting

48 In addition to the general points raised in the above paragraphs, commentators raised specific comments on the guidance in paragraph 7. The first of these specific comments concerned the proposal that the fair value of the award credits should take account of the time value of money. The main comments concerned:

a) the practical difficulties of evaluating the fair values of the rights. Considering those practical difficulties, discounting the nominal of the rebate appears to be unduly burdensome, and this for a result that would be in many cases not material.

b) opposition to discounting for conceptual reasons: a) the rights are not financial instruments, and therefore, the measurement of their fair value should not involve discounting, b) if discounting were to be pursued, then the measurement of the rights should take into account the effect of inflation, notably when the awards granted via the programme enable customer to get goods and services, not rebates to those goods and services.

49 The staff accept that, for awards expected to be claimed at an early date, the effect of discounting will often not be material, especially when award credits are low in

value or expressed in non-monetary terms, for which the effect of the time value of money will be (at least partly) offset by the increase in money value due to inflation. As discounting adds complexity to calculations there would be a case for reminding readers that it might not be necessary.

50 However, the guidance of paragraph 7 deals with specific facts and circumstances. Therefore, the case to be considered is one where the grant is materialised into a nominal monetary amount. It thus seems reasonable to discount the nominal value of those rebates to evaluate the fair value of the rights.

51 Furthermore, consideration of materiality is general principle of IFRSs that need not be referred to each time a new standard or interpretation is issued. The IFRIC and the Board have a policy of not referring to materiality in specific Standards and Interpretations, because to do so in the context of one requirement could imply that materiality did not apply in the context of other requirements.

Staff recommendation

52 The staff accept that materiality is an issue that will arise in many cases with regard to discounting. However, because of the general IASB/IFRIC's policy, the staff will recommend not to make any specific reference to materiality.

Question for the IFRIC

53 IFRIC members will be asked whether they agree with the staff recommendation.

Expected forfeiture rate

54 Some respondents consider that the expected redemption rate should not be taken into account for the evaluation of the fair value of the rights, but be considered afterwards for revenue recognition purposes by reducing deferred revenue by the amounts of actual forfeitures. This would lead to an accounting method similar to the one used in IFRS2, for vesting conditions.

Staff recommendation

55 The staff note that paragraphs BC178 - 180 of IFRS2 explain that the approach was only adopted in IFRS 2 for practical, rather than conceptual reasons. The staff also note that the approach would have the effect of continuously adjusting the obligation to fair value. The effect would be to re-measure the amount of revenue initially allocated to the award credits. Arguably, the revenue is fixed at the time of sale and any subsequent adjustments should only be to the rate of recognition, not the amount initially allocated.

56 The staff will recommend retaining the guidance that the fair value of the award credits should take into account expectations regarding forfeiture rates.

Question to the IFRIC

57 IFRIC members will be asked whether they agree with the staff analysis and recommendation.

PAPER 2(ii)—REVENUE RECOGNITION

1 Paper 2(ii) analyses comments received on the revenue recognition proposals in D20.

2 Specifically, it analyses comments relating to awards that the entity is responsible for supplying itself. Paper 2(iii) addresses comments relating to situations in which a third party assumes the obligation to supply the awards.

3 The revenue recognition requirements in D20 encompass requirements for forfeited award credits, ie those that are not redeemed by customers but are instead allowed to lapse unused. Because accounting for forfeiture is not well established in general, Paper 2(ii) starts off with a brief explanation of how forfeiture is dealt with in D20, and why.

D20 proposals

The proposed requirements

4 D20 proposed that:

> 8 The entity shall recognise revenue in respect of the award credits either:
>
> (a) in the periods, and reflecting the pattern, in which award credits are redeemed; or
>
> (b) [requirements if obligation is assumed by a third party, discussed in Paper 2(iii)].
>
> The amount of revenue recognised in (a) will be based on the number of award credits that have been redeemed relative to the total number expected to be redeemed.

5 Acknowledging the possibility that the expected costs of supplying awards might be (or become) higher than the amount of revenue that remains deferred, D20 went on to state that:

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

How these requirements would be applied

6 The proposed requirements would result in a form of stage of completion accounting. Entities would recognise revenue as follows:

a) *consideration allocated to award credits that are redeemed*—when the award credits are redeemed; and

b) *consideration allocated to award credits that are forfeited*—over the periods in which the other award credits are redeemed.

7 The staff has prepared a simple example to illustrate how it believes the requirements could be applied:

Facts of example

A supermarket grants 100 points, which customers can redeem for further goods from the supermarket. The entity allocates €1 of consideration to each point, deferring revenue of €100. It expects 80 points to be redeemed and 20 points to lapse unused, ie the forfeiture rate to be 25% of points redeemed. The points have no expiry date.

Year 1

At the end of the first year, 40 points have been redeemed in exchange for supermarket goods, ie half of those expected to be redeemed. The entity recognises revenue of (40 points / 80[1] points) x €100 = €50.

This process could alternatively be viewed as one that takes account of forfeited points by 'uplifting' the revenue allocated to redeemed points (€40) by the expected forfeiture rate (25% of points redeemed). If the entity did not change its expectations regarding forfeiture rates, it could continue to recognise revenue in future years by uplifting the revenue allocated to redeemed points by 25%. Once all 80 points had been redeemed, all of the €100 revenue would have been recognised.

Year 2

However, in the second year, the entity revises its expectations regarding forfeiture rates. It now expects that 90 points will be redeemed altogether.

By the end of the second year, a further 41 points have been redeemed, bringing the total number redeemed to 40[2] + 41 = 81 points.

The total revenue that the entity can now recognise is (81 points / 90[3] points) x €100 = €90. The entity has already recognised revenue of €50 in year 1, so it recognises a further €40 in year 2.

The change in estimates regarding redemption rates means that the entity now expects to supply more awards than it originally intended. Applying paragraph 10 of D20 (see paragraph 5 above), it will need to consider whether the remaining deferred revenue of €10[4] is sufficient to cover the costs of supplying the increased number of awards. If not, it will need to recognise any excess as an additional liability.

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[1] Total number expected to be redeemed.
[2] The points redeemed in Year 1.
[3] Revised estimate of total number expected to be redeemed.
[4] €100 initially deferred less €90 now recognised.

Year 3

In the third year, a further 9 points are redeemed, taking the total number of points redeemed to 81 + 9 = 90. The entity continues to expect that only 90 points will *ever* be redeemed, ie that it is unlikely that any more points will be redeemed after year 3. So the cumulative revenue to date is (90 points / 90[5] points) x €100 = €100. The entity has already recognised €90 of revenue (€50 in year 1 and €40 in year 2). So it recognises the remaining €10 in year 3. All of the revenue initially deferred has now been recognised.

It is of note that the €10 of revenue recognised in Year 3 equals the amount originally allocated to the 9 points redeemed in that year (€9), uplifted by the current estimated forfeiture rate (ie 1 point for every 9 points redeemed, or 11%). The only years in which there is not this simple relationship between revenue recognised and points redeemed are those in which the entity revises its estimates of forfeiture rates, ie year 2 in this example.

[5] Total number still expected to be redeemed.

Basis for Conclusions

8 Paragraphs BC11 and BC12 of the Basis for Conclusions accompanying D20 explained the proposed requirements regarding revenue recognition.

> BC11 The consideration allocated to award credits represents the amount that the entity has received for accepting an obligation to supply awards *if* customers redeem the credits. The estimate of this amount reflects both the value of the awards and the entity's expectations regarding the proportion of credits that will be redeemed, ie the risk of a claim being made. The entity has received the consideration for accepting the risk, whether or not a claim is actually made. Hence, the draft Interpretation requires revenue to be recognised as the risk expires, ie in the periods, and reflecting the pattern, in which award credits are redeemed.
>
> BC12 After granting award credits, the entity may revise its expectations about the proportion that will be redeemed. The change in expectations does not affect the consideration that the entity has received for supplying awards: this consideration (and hence the revenue) was fixed at the time of the initial sale. However, it may affect the costs the entity will incur to supply awards. If redemption rates are expected to increase to the extent that the unavoidable costs of supplying awards will exceed the consideration received and receivable for them, the entity has an onerous contract. The draft Interpretation therefore highlights the requirement of IAS 37 to recognise an additional liability for the excess.

Comments on the requirements

9 Most of the comments on the proposed revenue recognition requirements were requests for more guidance. Paper 2(ii) therefore focuses on these suggestions—see next section. However, before the IFRIC can discuss additional guidance, it will need to confirm that it does not wish to change the requirements themselves. This section therefore addresses four comments received challenging aspects of the requirements and explains why the staff do not think that any changes are needed in the light of these comments.

There should be no requirements

10 One commentator thought that the Interpretation should not include any requirements regarding revenue recognition:

> Our greatest discomfort with D20, however, is its total disregard for achieving a principle-based solution. We have noticed an increasing tendency for IFRIC consensuses to assume undue size as they build in highly detailed implementation rules which are far from clarifications of principle. … Why is a page and a half necessary to state the simple principle that award credits should be accounted for as a separately identifiable component of the sales transaction in which they are granted? The rest of paragraphs 5-11 could much better be consigned to Illustrative Examples or—even better—dropped where statement of the consensus principle is already sufficient for entities to know how to proceed. We strongly urge IFRIC not to yield to pressure to give detailed application rules but to support and give more credibility to the IASB's avowed preference for principles-based accounting guidance. *CL44 Swiss Holdings*

11 The staff understand the desire not to add unnecessary detail. But it can be argued that, without the (fairly high-level) requirements in paragraph 8 of D20, significantly divergent practices will emerge. IAS 18 does not specifically address forfeiture. Forfeiture is a major factor affecting customer loyalty award credits. Without any requirements, the Interpretation may not meet its aim of eliminating significant differences in measurements of obligations—in this case, statement of the consensus principle is arguably *not* sufficient for entities to know how to proceed.

12 Hence the staff will recommend that revenue recognition requirements are included in the Interpretation – paragraph 8 of D20 should not be deleted.

13 IFRIC members will be asked whether they agree.

The requirements do not reflect the objectives set out in the basis for conclusions

14 *CL9 Grant Thornton* and *CL33 EFRAG* both accepted the objectives of the revenue recognition approach set out in the Basis for Conclusions in D20, ie that (i)

revenue should be recognised to reflect the pattern of redemption / expiry of risk, and (ii) changes in estimates of forfeiture rates would not lead to remeasurement of the amount of consideration allocated to the award credits, but would affect the timing of recognition.

15 However, both argued that the requirements proposed in the Consensus were inconsistent with these objectives. They both illustrated their concerns using examples in which:

- no award credits are redeemed in the first year after grant; and
- at the end of the first year, the entity reduces its forecast of the number that will be redeemed in future.

16 Both commentators observed that, applying the D20 Consensus, no revenue would be recognised in that first period. They thought that this outcome was wrong. *Grant Thornton* argued that the reduction in forecast redemption rates reflected an expiry of risk, which should lead to revenue recognition. *EFRAG* argued that the recognition of no revenue was inconsistent with the requirement that revenue should reflect the pattern in which award credits were redeemed.

17 In response to these suggestions, it can be argued that a change in the forecast redemption rates does not signal the *expiry* of risk. Rather it signals a change in the *estimate* of the risk. If revenue were recognised when no credits had been redeemed, the timing of recognition would *not* reflect the pattern of redemption.

18 The staff further observe that, if there were an *increase* in expected redemptions, the commentators appear to be suggesting that deferred revenue should also be increased. If no points were redeemed in the first year, the amount of deferred revenue would be increased to a balance greater than that initially allocated to the award credits. The increase would represent a retrospective reduction in the revenue already recognised in respect of the initial sale.

19 The staff believe that there is no inconsistency between the requirements proposed in the Consensus and the objectives set out in the Basis for Conclusions.

20 IFRIC members will be asked whether they agree.

Consistency with IAS 8

21 CL12 *South African Institute of Chartered Accountants* suggested that remeasurement of the liability was necessary to comply with IAS 8:

> BC12 of the draft interpretation states that once an estimate of forfeiture is made on initial recognition of the first component of the multiple-element transaction, no change may be made as a result of a change in this estimate. We believe that this is inconsistent with IAS 8 *Accounting policies, changes in accounting estimates and errors*, and should be amended. *CL12 South African Institute of Chartered Accountants*

22 In contrast, *CL51 KPMG* took the view that D20 *was* consistent with IAS 8. But KPMG suggested that, to avoid confusion, the Basis for Conclusion should clarify why there was no conflict:

> The draft interpretation proposes that changes in estimates of redemptions are accounted for prospectively by adjusting the amount of revenue recognised per award, rather than adjusting the deferred revenue balance. We believe that the method proposed in D20 is consistent with the requirements of IAS 8… We also believe that the requirement for revenue to be fixed at the time of the initial sale is consistent with IAS 18.9, which states that "Revenue should be recognised at the fair value of the consideration received or receivable". To avoid confusion in practice, we believe that the IFRIC should consider explaining in the Basis for Conclusions why the requirement not to adjust deferred revenue for changes in estimates does not conflict with IAS 8. *CL51 KPMG*

23 [Paragraph omitted from observer note.]

24 If the IFRIC wished to refer to IAS 8 in the Basis for Conclusions, paragraphs BC11 and BC12 could be amended, perhaps with something like:

BC11 The consideration allocated to award credits represents the amount that the entity has received for accepting an obligation to supply awards *if* customers redeem the credits. The estimate of this amount reflects both the value of the awards and the entity's expectations regarding the proportion of credits that will be redeemed, ie the risk of a claim being made. The entity has received the consideration for accepting the risk, whether or not a claim is actually made. Hence, the draft Interpretation requires revenue to be recognised by reference to the stage of completion as the risk expires, ie in the periods, and reflecting the pattern, in which award credits are redeemed.

BC12 After granting award credits, the entity may revise its expectations about the proportion that will be redeemed. The change in expectations does not affect the consideration that the entity has received for supplying awards: this consideration (and hence the revenue) was fixed at the time of the initial sale. Hence, the change in expectations does not affect the measurement of the original obligation. Instead, it affects the amount of revenue recognised for each award credit that is redeemed. The change in expectations is thus accounted for in the period of change and future periods, in accordance with paragraph 36 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

BC13 ~~However, it~~ An increase in expected redemption rates may also affect the costs the entity will incur to supply awards. If redemption rates are expected to increase to the extent that the unavoidable costs of supplying awards will exceed the consideration received and receivable for them, the entity has an onerous contract. The draft Interpretation therefore highlights the requirement of IAS 37 to recognise an additional liability for the excess.

25 The staff will recommend the addition of text such as that outlined above..

26 IFRIC members will be asked whether they agree.

Comments on adequacy of guidance

Comments

27 As noted in the last section, few commentators disagreed with the proposed revenue recognition requirements. However, many commentators thought that more guidance was needed on how to apply them.

28 Some commentators—*CL17 FirstRand Banking Group, CL30 Inst. Chartered Accountants in England and Wales, CL33 PricewaterhouseCoopers, CL38 Ernst & Young, CL50 Australian Accounting Standards Board* and *CL51 KPMG*—thought that the Consensus did not adequately address revenue recognition for points that had either expired or for which the possibility of redemption had become remote.

> …paragraph 8(a) of the Consensus should also mention that revenue is recognised when award credits expire. At present, paragraph 8 only covers expirations implicitly in the reference at its end to "the total number expected to be redeemed". *CL50 AASB*

> An entity might obtain reliable evidence that the probability of an outstanding award credit being redeemed has become remote. This will occur when the actual forfeiture rate is higher than the rate estimated when the award credit was issued. We believe the interpretation should state that award credits should be recognised in income when the possibility of redemption becomes remote. *CL33 PricewaterhouseCoopers*

29 Several commentators, *CL11 Lane, Clark & Peacock, CL18 Korea Accounting Institute, CL21 Institute of Chartered Accountants in Ireland, CL54 European Federation of Accountants, CL55 EFRAG* and CL56 *IOSCO,* referred in particular to a need for more guidance on how to account for changes in estimates:

> We agree that revenue related to award credits should be recognised in the periods, and reflecting the pattern, in which award credits are redeemed. However, it is not clear how changes in expectations about the proportion of credits that will be redeemed or changes in the values of the awards expected to be redeemed are treated. While paragraph BC12 appears to prohibit changing the consideration allocated to the award credits, it is not clear how changes in expectations impact the rate of revenue recognised. We believe that clear principles, whether by

> reference to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* or through other guidance, should be provided. *CL56 IOSCO*

30 *CL30 ICAEW, CL33 PricewaterhouseCoopers, CL38 Ernst & Young,* and *CL51 KPMG* referred specifically to the statement in the Basis for Conclusions that the amount of revenue initially allocated to award credits would never be changed and recommended highlighting and explaining this point in the Consensus itself:

> While we agree with the proposed Interpretation that the amount of revenue allocated to award credits is *fixed* at initial sale (BC12), we believe that it would enhance understandability of the draft Interpretation if IFRIC explains how it arrived at its conclusion and provides some further clarification / illustrative examples on how subsequent changes in estimates are accounted for. *CL51 KPMG*

> The draft Interpretation does not explain how to account for factors that affect the fair value of the award credits after they have been issued; for example, modifications to a loyalty scheme or changes in the estimated redemption rate. Paragraphs 10 and BC12 of the draft Interpretation imply that the revenue deferred in the balance sheet in respect of an award credit would not be altered subsequent to its initial measurement. This requirement should be made more explicit. *CL33 PricewaterhouseCoopers*

> The final Interpretation should set out more clearly the principles to be applied in dealing with awards forfeited by customers. It should be clear from BC12 that the value attributed at the time of the initial sale should not be revisited, but we believe this point should be made explicitly in the consensus, and guidance is needed on the treatment of the balance of unredeemed awards on expiry. *CL30 ICAEW*

31 *CL21 Institute of Chartered Accountants in Ireland* asked whether the effect of re-estimating forfeiture rates would be recognised through revenue. *CL38 Ernst & Young* thought that paragraph 10 of D20 did not make it sufficiently clear that an additional liability for onerous contracts would be recognised only if the costs of supplying awards were expected to exceed the amount of revenue deferred.

32 *CL51 KPMG* correctly observed that the requirement to recognise revenue 'based on the number of award credits that have been redeemed relative to the total number expected to be redeemed' could be applied in two ways:

a) *using a 'cumulative catch-up' approach.* Total revenue earned to date would be calculated on the basis of the cumulative redemptions to date relative to the current estimate of total redemptions. Revenue for the period would be measured by deducting from this total the revenue recognised in previous periods. This approach is used in the staff's illustrative example following paragraph 7 above.

b) *using a period by period approach.* In each period, revenue would be based on the number of redemptions in that period relative to the number of points expected to be redeemed in current and future periods.

33 *KPMG* did not give a view on which of the two approaches it preferred, but having highlighted the challenges in the calculation, it suggested that the Interpretation would benefit significantly from an example illustrating at least one of the possible approaches. *CL30 Institute of Chartered Accountants in England and Wales, CL38 Ernst & Young* and *CL55 EFRAG* also suggested that an illustrative example might help explain the requirements:

> We recommend that the IFRIC provide further clarification including illustrative examples on how subsequent changes in estimates are accounted for, including the recognition of deferred revenue when award credits have lapsed or are no longer expected to be redeemed. … We believe that the draft Interpretation would [also] benefit extensively from including an example to illustrate the proposal in paragraph 10. *CL55 EFRAG*

> The last sentence of paragraph 8 states that the revenue recognised will be based on the total number of award credits that have been redeemed relative to the total number expected to be redeemed. Whilst we agree with this statement, a numerical example would be of use to clarify this point. *CL30 ICAEW*

> We would recommend that the IFRIC consider providing more guiding principles about when the deferred revenue can be released and include

some examples illustrating the interrelationship between the measurement of the onerous contract liability and the release of deferred revenue. *CL38 Ernst & Young.*

34 [Paragraph omitted from observer note.]

Staff analysis

35 If the Interpretation is to succeed in standardising practice, it needs to state its requirements clearly. The comments the IFRIC have received indicate that the requirements are not clear enough.

36 [Paragraph omitted from observer note.]

37 Any additional guidance could take the form of general application guidance and/or an illustrative example. [Rest of paragraph omitted from observer note.]

38 One possible problem with the example used in this paper is that it might not be obvious to readers that, in some circumstances, a simpler approach would achieve the same result. For example, if an entity issues award credits that expire three years after being granted, and if it has evidence that the rate of redemption is materially the same in each of the three years, it could simply recognise the deferred revenue evenly over the three years. Or if awards are so easily redeemed that any forfeiture is likely to be immaterial, an entity could assume no forfeiture and recognise the revenue attributed to each award credit when it is redeemed. The deferred revenue balance at any future date would be measured simply by reference to the number of points outstanding.

39 If an example were added to the Interpretation, it might be worth adding a caveat explaining that the example illustrates only one acceptable approach and giving examples of situations in which a simpler approach could be adopted.

Staff recommendations

40 The staff will recommend adding an illustrative example similar to that set out in paragraph 7 of this paper, with a caveat that in some circumstances, where simplifying assumptions can be made, other simpler approaches would also meet the requirements of the Consensus.

Questions for the IFRIC

41 IFRIC members will be asked whether they agree that more guidance is needed.

42 If they agree, they will be asked whether they also agree that the best type of guidance would be an illustrative example.

43 If they agree to the addition of an illustrative example, they will be asked whether they:

a) think that the illustrative example used in Paper 2(ii) correctly interprets the requirements and is suitable for the Interpretation.

b) agree that there should also be a brief reference to circumstances in which a simpler approach could be adopted.

Other comments

44 Other more minor comments on the revenue recognition proposals are listed in an Appendix to Paper 2(ii), along with the staff's response and any action proposed. None of these comments will be discussed in the meeting unless raised for discussion by an IFRIC member. [The Appendix has been omitted from the observer note.]

PAPER 2(iii)—AWARD SUPPLIED BY THIRD PARTIES

1 Paper 2(iii) discusses situations in which the entity engages a third party to supply awards to its customers. It:

a) analyses comments received on the proposed requirements for revenue recognition and presentation in such situations; and

b) considers whether an illustrative example should be added to clarify the requirements, and if so, what accounting treatment the example should illustrate.

D20 proposals

Revenue recognition

2 D20 specifically addressed the revenue recognition implications of situations in which entities engage third parties to supply the awards:

> 8 The entity shall recognise revenue in respect of the award credits either:
>
> (a) in the periods, and reflecting the pattern, in which award credits are redeemed and the entity fulfils its obligation to supply awards to the customer[6]; or
>
> (b) if a third party assumes the obligation to supply the awards to the customer, when that third party assumes the obligation.
>
> The amount of revenue recognised in (a) will be based on the number of award credits that have been redeemed relative to the total number expected to be redeemed.
>
> 9 Whether and when a third party assumes the obligation to supply awards to the customer depends on the terms of its agreement with the entity. The third party might assume the obligation as soon as the award credits are granted, in which case the entity recognises revenue at the same time as the initial sale. In contrast, if customers can choose to claim awards from either the entity or the third party, the third party might assume the obligation only when a customer chooses to claim awards from it.

[6] This additional text is proposed in Appendix to Paper 2(ii). It is necessary to address situations in which award credits are redeemed some time before the goods or services are supplied, eg when air miles are redeemed for tickets for a future flight.

3 The Basis for Conclusions explained the proposed requirements as follows:

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

Measurement/presentation

4 Paragraph 8 of IAS 18 states that:

> 8 Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties, such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

5 If the entity engages a third party to supply awards, it ought to consider whether the consideration allocated to the award credits is its own revenue, or whether it has collected the consideration on behalf of the third party. The Consensus in D20 did not address this issue, the reason being explained in the Basis for Conclusions.

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

How the proposed requirements would be applied

6 The following example illustrates how the staff think the proposed requirements could apply if a third party immediately assumed the obligation to supply awards:

Facts of example

A retailer of electrical goods operates a customer loyalty programme. Programme members are granted 2 air miles with each $1 they spend. The air miles can be redeemed for discounted air travel with a specified airline, subject to availability. The retailer notifies the airline of the number of air miles granted each period and immediately becomes liable to pay the airline $0.0045 per air mile.

In one period, the retailer grants 2 million air miles, for which it is required to pay the airline $9,000.

Allocation of consideration to air miles

The retailer estimates that the relative fair value of the air miles is $10,000, so allocates $10,000 of the consideration it has received from the sales of its electrical goods to the air miles.

Timing of recognition

The terms of the agreements between the customers, retailer and airline are such that the retailer retains no obligations in respect of the air miles. So it immediately recognises the $10,000 consideration that it has allocated to the air miles—it does not defer any revenue. It also immediately recognises a $9,000 liability for its obligation to pay the airline.

Revenue measurement and presentation

The retailer considers the requirements of paragraph 8 of IAS 18 *Revenue*.

Approach A: If the retailer judges that the consideration allocated to the air miles has been collected on its own account, it recognises the gross amount allocated to the air miles ($10,000) as revenue and the amount payable to the airline ($9,000) as an expense.

Approach B: If the retailer judges that the consideration allocated to the air miles has been collected on behalf of the airline, it recognises as revenue only the net $1,000 it retains on its own behalf, ie the difference between the $10,000 allocated to the air miles and the $9,000 payable to the airline.

Required accounting entries

Because in this example the retailer recognises all revenue when it sells the electrical goods, the accounting entries are straightforward in practice. The retailer does not necessarily need to calculate how much consideration to allocate to the air miles. It simply accrues its $9,000 obligation to pay the airline, either as an expense (A) or as a deduction from revenue (B).

Comments — gross or net presentation

Comments

7 The most controversial aspect of these proposals proved to be the decision not to address gross versus net presentation.

8 *CL1 Mr. Elmar Venter, CL12 South African Inst. of Chartered Accountants, CL13 Swiss GAAP FER, CL17 FirstRand Banking Group, CL30 Inst. of Chartered Accountants in England and Wales, CL33 PricewaterhouseCoopers, CL34 UK 100 Group of Finance Directors, CL50 Australian ASB and CL54 European Federation of Accountants* thought that the issue should be addressed in the Interpretation, not postponed for another project.

> …we urge the Committee to reconsider because we believe that the Interpretation would be deficient and may lead to incorrect accounting if the issue is not addressed. *CL34 UK 100 Group*

> The issue might not necessarily be one of presentation only, as recognising fee income results in different considerations in terms of IAS 18, than recognising revenue for the supply of goods or other services. *CL1 Mr. Elmar Venter*

> Paragraph 8(b) states that if a third party assumes the obligation to supply the awards to the customer then revenue may be recognised at the point the obligation is transferred. But if the entity is acting as principal in the transaction, revenue may only be recognised if performance has occurred — that is, if the customer has redeemed the points. If the entity is not principal in the arrangement, then the obligation to perform rests with the third party in any case. Paragraph 8(b) therefore needs to be amended to reflect the fact that not only the presentation of revenue but also the timing of recognition of the revenue will be different depending on whether the seller is acting as principal or agent. *CL30 ICAEW*

> … This is not a matter merely of presentation but of measurement and recognition of revenue. The approach proposed in the draft Interpretation is inconsistent with paragraph 8 of IAS 18 and is likely to result in divergence in its application and inconsistency with other aspects of revenue recognition. … When the seller collects revenue for award credits but does not provide goods or services to the customer on redemption of the award credits, it may be acting as agent rather than principal. It would be inconsistent with paragraph 8 of IAS 18 for the seller to recognise as revenue all of the consideration received for the award credits in these circumstances. Paragraph 9 of the draft Interpretation should be amended to require the seller to apply paragraph 8 of IAS 18 to determine the amount of revenue that should be recognised when the awards are redeemed by customers to obtain goods or services from a third party. … *CL33 PricewaterhouseCoopers*

9 *CL30 Institute of Chartered Accountants in England and Wales* and *CL54 European Federation of Accountants* highlighted in particular programmes involving multiple participants:

> Another important principal versus agent question that needs to be addressed is in relation to the recognition of revenue where the scheme is one in which many entities participate and award credits can be redeemed at any of the entities. In such circumstances, the scheme is normally administered by a third party and the entities participating would act as agents when the award credits are granted. If this were not the case, revenue would be recognised when the obligation was transferred to the third party (under paragraph 8(b)) but those same points could be redeemed at the issuing entity and hence further revenue recognised for the redemption of the points. This treatment would not be acceptable (as the same revenue would in effect be recognised twice) and hence the entity must be acting as agent in the first transaction. This would be consistent with the commercial substance of schemes such as Nectar in the UK, where the scheme itself is actively marketed in its own right. *CL30 ICAEW*

Staff analysis

10 [Paragraphs 10 and 11 omitted from observer note.]

Options

12 The staff have identified three options for the IFRIC in the light of the commentators' views and staff analysis.

Option 1 — Make no changes

13 The first option would be to add nothing more to the requirements proposed in D20.

Option 2 — cross refer to paragraph 8 of IAS 18

14 A second option would be to add a cross reference to paragraph 8 of IAS 18, to highlight the issue to readers.

15 [Paragraph omitted from observer note.]

Option 3 — rewrite the requirements

16 A criticism of Option 2 could be that it highlights the question to readers but without giving very much indication of what the answer should be. It could be argued that the requirements should more clearly link immediate recognition of revenue with net presentation. This would require significant redrafting of D20, perhaps along the following lines:

> 8 If the entity supplies the awarded goods or services itself, it shall recognise the consideration allocated to award credits as revenue in the periods, and reflecting the pattern, in which award credits are redeemed and the entity fulfils its obligations to supply awards to the customer. The amount of revenue recognised will be based on the number of award credits that have been so redeemed relative to the total number expected to be redeemed.

8A	If the entity engages a third party to supply the awards, management shall assess whether the entity has collected the consideration allocated to the award credits on its own account (ie as the principal in the transaction) or on behalf of the third party (ie as an agent for the third party). If the entity has collected the consideration on behalf of the third party, it shall: (a) measure its revenue as the net amount retained on its own behalf, ie the difference between the consideration allocated to the award credits and the amount payable to the third party for supplying the awards; and (b) recognise this net revenue in the periods, and reflecting the pattern, in which the third party assumes the obligation to supply the awards. If the entity has collected the consideration on its own behalf, it shall measure its revenue on a gross basis and recognise it in accordance with paragraph 8.

17 [Paragraph omitted from observer notes.]

Questions for the IFRIC

18 IFRIC members will be asked whether they support:

<u>Option 1</u> to make no changes

<u>Option 2</u> to add a cross reference to IAS 8

<u>Option 3</u> to rewrite requirements to specifically link the revenue recognition requirements with net or gross presentation.

19 If option 2 or 3 is chosen, IFRIC members will be asked if they are happy with the drafting of the additional text proposed.

Comments — mixed programmes

20 A further issue needs to be considered if the IFRIC chooses either Option 1 or Option 2 in the previous section. *It does not arise, and so will not be discussed at the meeting if the IFRIC chooses Option 3.*

21 Some commentators asked for more guidance on how the proposed revenue recognition requirements would be applied to programmes that offered a choice of awards, some of which would be supplied by the entity itself and some of which would be supplied by a third party.

22 The staff recommend that the Interpretation should <u>not</u> provide any further guidance in this area. The Interpretation already addresses both awards provided by the entity and awards provided by third parties. The way in which the requirements are blended when applied to mixed programmes will depend on the terms of the programmes.

23 However, when thinking about how the requirements would be applied to various different types of mixed programmes, the staff identified a possible weakness in the wording of the revenue recognition requirements in D20. If the IFRIC decides to retain the requirements in paragraph 8 of D20 (ie chooses Option 1 or Option 2 in the previous section of this paper), the wording may need to be reconsidered.

24 The problem is highlighted if, for example, the programme offers customers an option to redeem points for a gift certificate for another retailer. In this case, the third party (the other retailer) does not automatically assume the obligation to supply the awards and the entity does not pay the third party for all points it grants. It pays only for those redeemed for a gift certificate at a later date. The entity therefore needs to account itself for the revenue allocated to points that are ultimately forfeited.

25 However, as currently drafted, the revenue recognition requirements may appear to accommodate forfeiture only if awards are supplied by the entity itself (ie if paragraph 8(a) applies). The staff therefore suggest rewording requirements so that it is clearer that the same approach to forfeiture also applies when a third party assumes the obligations.

26 The staff will recommend the following changes:

> 8 The entity shall recognise revenue in respect of the award credits in the periods, and reflecting the pattern, in which either:
>
> (a) ~~in the periods, and reflecting the pattern, in which~~ award credits are redeemed and the entity fulfils its obligation to supply awards to the customer; or
>
> (b) ~~if~~ a third party assumes the obligation to supply the awards to the customer~~, when that third party assumes the obligation~~.
>
> The amount of revenue recognised ~~in (a)~~ will be based on the number of award credits that have been redeemed by customers or assumed by the third party relative to the total number expected to be redeemed by customers or assumed by the third party.

27 IFRIC members will be asked whether they agree with the proposed drafting changes.

Other comments

28 Two other significant comments were received on the proposed requirements for awards provided by third parties.

Classification of expense in gross presentation

29 *CL17 FirstRand Banking Group* asked for further guidance on the classification of payments to third parties for supplying awards:

> If the entity can report gross revenue, then will the cost of the awards be considered as marketing expenses or any other? The classification of this expense is important and should be carefully considered, because it might have an impact on industries when competitors in certain industries compare certain types of costs for example advertising and marketing type costs.

30 [Paragraphs 30 and 31 omitted from observer note.]

32 The staff will recommend that expense classification should not be addressed in the Interpretation.

33 IFRIC members will be asked whether they agree.

Meaning of 'assumes the obligation'

34 This final comment is relevant, and will be raised for discussion, if the IFRIC chooses Option 1 or Option 2 in response to the question in paragraph 18. *The staff think it is not relevant, and so need not be discussed at the meeting, if the IFRIC chooses Option 3.*

35 *CL1 Mr Elmar Venter* suggested that more guidance was required on when a third party should be regarded as 'assuming' the obligation. *CL50 Australian Accounting* Standards Board argued that revenue should be recognised only if the customer has no recourse to the entity itself:

> As indicated above, the AASB agrees with the proposal in paragraphs 8(b) and 9 of D20 that revenue should be recognised when a third party assumes the entity's obligations to supply awards to the customer. However, the AASB considers this should only occur if the assumption is on a non-recourse basis. This is because, consistent with accounting for award credits under paragraph 13 of IAS 18, the extinguishment of the entity's obligation to supply awards gives rise to revenue. Under a

non-recourse assumption[7], the entity's legal obligation is extinguished in return for the consideration paid by the entity for the assumption, and thus revenue arises. However, under an assumption in which the customer continues to have recourse to the entity, the entity purchases the right to the third party's promise to provide the awards (an asset) but its obligation is not extinguished. Therefore revenue should not be recognised when the latter form of assumption occurs.

The AASB observes that the last sentence of paragraph BC13 of the Basis for Conclusions supports its recommendation. The sentence is: "However, if the entity has *no obligations* in respect of the delivery of the awards, it should not defer revenue. (emphasis added) *CL50 Australian ASB*

36 [Paragraph omitted from observer note.]

37 The AASB recommendation could be achieved by further amending paragraph 8 of D20 (as revised in paragraph 26 above) as follows:

> 8 The entity shall recognise revenue in respect of the award credits in the periods, and reflecting the pattern, in which either:
>
> (a) award credits are redeemed and the entity fulfils its obligation to supply awards to the customer; or
>
> (b) a third party assumes the obligation to supply the awards, such that the entity has no remaining obligations to the customer.
>
> The amount of revenue recognised will be based on the number of award credits that have been redeemed by customers or assumed by the third party relative to the total number expected to be redeemed by customers or assumed by the third party.

38 IFRIC members will be asked whether they wish to amend the text.

7 This term has the same meaning as *legal assumption*, as referred to in the IASB-FASB Revenue Recognition project, but the AASB prefers it because it is more self-explanatory.

Illustrative example

39 At the January IFRIC meeting, members suggested adding to the Interpretation an example illustrating how D20 would be applied if a third party immediately assumed the obligation to supply awards. They suggested that an example would help demonstrate that the accounting approach required in such circumstances is very similar to a cost accrual approach.

40 As some IFRIC members observed at the time, the IFRIC would need to consider whether and how any illustrative example should address the issue of gross or net measurement of revenue.

41 Having now discussed the issues surrounding gross or net measurement further, the IFRIC can now return to the suggestion that it include an illustrative example.

42 The staff will recommend the addition of an illustrative example, particularly if the IFRIC decides to include an example addressing revenue recognition when the entity supplies awards itself (as recommended in Paper 2(ii)).

43 Regarding the content of the example, the staff will recommend that:

a) a simple example, similar to that given at the start of Paper 2(iii) (following paragraph 6) would be sufficient.

b) if this example is used, the section of it that discusses 'revenue measurement and presentation' should be included only if the IFRIC chooses to discuss gross or net presentation within the Consensus itself (ie, chooses Option 2 or Option 3 in response to the question in paragraph 18), and

c) the specific fact pattern in this example is such that it is more likely that the retailer should measure its revenue from award credits on a net basis (ie using Approach B). Hence, the example should illustrate only Approach B.

Questions for IFRIC members

44 IFRIC members will be asked whether they wish to add an example illustrating revenue recognition when a third party supplies the awards.

45 If they do, they will be asked whether they agree with the staff proposals in paragraph 43 regarding the form and content of the example.

PAPER 2(iv)—OTHER ISSUES

1 Paper 2(iv) addresses comments on aspects of the D20 that have not been addressed in previous papers.

Customer relationship intangible assets

D20 proposal

2 An objective of loyalty programmes is to encourage customers to continue purchasing goods and services from the entity, ie to increase future sales volumes. During its early discussions, the IFRIC considered a view that, because entities expect to receive benefits in future as a result of granting award credits, it seemed wrong that they should have to recognise an obligation (and hence expense) at the time of the initial sale.

3 The IFRIC took the view that the obligation to provide the awards arose at the time of the initial sale. Hence it should be recognised at that time. The IFRIC acknowledged that the entity might benefit from enhanced sales in future as a result of having awarded the credits. However, the benefits did not eliminate the obligation. Rather they reflected a separate internally-generated customer relationship intangible asset.

4 Applying the requirements of IAS 38 *Intangible Assets*, the asset would rarely be recognised. This might appear to misrepresent the economic position of the entity. However, award credits were being treated no differently from other costs (eg marketing expenses) incurred with a view to enhancing future sales.

5 Rather than address the recognition of intangible assets directly, the draft Interpretation simply noted that:

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

Comments

6 Seven respondents—*CL12 South African Inst. Chartered Accountants, CL27 Inst. For Accountancy Profession in Sweden, CL33 PricewaterhouseCoopers, CL38 Ernst & Young, CL43 German Accounting Interpretations Committee and CL50 Australian Accounting Standards Board*—objected to this paragraph of D20.

7 They argued that the paragraph was confusing. It seemed to suggest that there were circumstances in which customer relationship intangible assets *would* be recognised, whereas the requirements of IAS 38 were such that recognition would be extremely unlikely. Also, the paragraph seemed to be of no relevance to the issue being addressed in the Interpretation, ie whether the entity's obligations should be recognised and measured by deferring revenue or accruing costs.

8 The commentators suggested that the IFRIC should either remove the paragraph or give further guidance on what it meant.

Staff analysis

9 [Paragraphs 9-11 omitted from observer note.]

Staff conclusions and recommendations

12 The staff will recommend that paragraph 11 is deleted from the Consensus, with only a brief explanation being added to the Basis for Conclusions—within a (yet to be drafted) note of changes from D20. The explanation could be that the awards are unlikely to qualify for recognition under IAS 38 and the issue is peripheral to the Interpretation.

Questions for the IFRIC

13 IFRIC members will be asked whether they agree that paragraph 11 should be deleted from the Consensus.

14 IFRIC members will be asked whether they agree that there is no need to discuss intangible assets in the Basis for Conclusions either.

Transitional arrangements

15 Paragraph 12 of the D20 proposed that the Interpretation should be applied retrospectively.

Comments

16 Five commentators, *CL27 Inst for Accountancy Profession in Sweden, CL29 German Accounting Standards Board, CL43 German Accounting Interpretations Committee, CL50 Australian Accounting Standards Board* and *CL51 KPMG* disagreed with requiring retrospective application.

17 All pointed out that retrospective application may be very cumbersome or impracticable for long-outstanding award credits:

> If an entity has previously accounted for award credits as an expense at the time of the "initial sale", measured by reference to the estimated cost of supplying the goods or services, it might not possess the information needed to retrospectively allocate the customer consideration for now-completed "initial sales" to those award credits. In other words, the entity will have been measuring the exit values of its award credits (which could have been performed in aggregate for similar types of awards) but would now be required to identify the entry values of all the unredeemed award credits, separately for each "initial sale". Therefore the AASB suggests that the Interpretation should apply prospectively from its effective date. *CL50 AASB*

18 One commentator, CL43 *German Interpretations Committee* also pointed out that hindsight bias would be unavoidable.

Staff analysis

19 [Paragraphs 19-22 omitted from observer note.]

Staff recommendations

23 The staff will recommend that the Interpretation incorporate no specific transitional arrangements, so that the general requirements of IAS 8 become applicable—retrospective application would be required except to the extent that an entity could demonstrate that it was not practicable.

24 The staff will recommend that, to avoid any ambiguity over whether IAS 8 applies, the sentence requiring retrospective application (in paragraph 12 of D20) should be deleted.

Question for the IFRIC

25 IFRIC members will be asked whether they agree with the staff recommendations.

Effective date

26 D20 proposed that the Interpretation should be effective for periods beginning three or more months after it is issued in final form.

Comments

27 Four commentators argued that this lead-in time was insufficient. It would not give preparers in some industries sufficient time to:

a) implement the extensive changes to systems and procedures that would be required to comply with the Interpretation on an ongoing basis. *CL12 South African Institute of Chartered Accountants, CL22 South African Airways*

b) compile the data required to apply the Interpretation retrospectively. *CL51 KPMG*

CL33 PricewaterhouseCoopers also highlighted the particular difficulties for entities that are required to prepare quarterly information.

28 Another airline (CL53), whilst not commenting explicitly on the effective date, described the extensive systems changes that it would need to make to comply with the requirements of the Interpretation.

29 *CL12 South African Institute of Chartered Accountants* and *CL22 South African Airways* suggested that the Interpretation should not become effective until 2009 (in line with the IASB's commitment not to issue any new standards or major amendments to existing standards before then).

30 *CL33 PricewaterhouseCoopers* suggested extending the lead-in period to at least six months.

Staff analysis

31 [Paragraphs 31 and 32 omitted from observer note.]

Staff recommendations

33 The staff will recommend that the proposed lead-in period should be extended from three to approximately six months, (the exact effective date being set when the publication date is more certain).

Question for the IFRIC

34 IFRIC members will be asked whether they agree.

Other comments

35 Other sundry comments are listed in the Appendix to Paper 2(iv), along with the staff's response and any action proposed. None of these comments will be discussed in the meeting unless raised for discussion by IFRIC members. [The Appendix has been omitted from the observer note.]

PAPER 2(v)—CHANGES REQUESTED AT PREVIOUS MEETING

1 At its January meeting, the IFRIC discussed comments received on the scope of, and overall approach proposed by, D20. In the light of these comments, the IFRIC requested some changes to the drafting of the Interpretation.

2 The changes are reflected in the revised draft Interpretation [Paper 2(vi), omitted from observer note]. The purpose of Paper 2(v) is to obtain IFRIC approval for the drafting of the more significant changes.

Scope

3 The scope paragraph of D20 stated that:

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

4 At the January meeting, the IFRIC asked the staff to revise the wording of this paragraph to make it clearer that the Interpretation applied only to award credits granted (i) as part of a sales transaction, and (ii) along with the sale of other goods and services. The D20 wording (in particular the first sentence) implied that the Interpretation was seeking to address customer loyalty programmes more widely.

5 IFRIC members suggested that as part of the redrafting, the order of the two sentences in the scope paragraph of D20 should be reversed.

6 The staff have therefore drafted changes to the scope paragraph.

7 To explain (and further highlight) the scope limitation, a new ‘scope’ subheading has been included in the Basis for Conclusions and paragraph BC3 has been expanded slightly. (See changes to paragraphs BC3 and BC4 in Paper 2(vi))

Questions for the IFRIC

8 IFRIC members will be asked whether the new wording in the Consensus and in paragraphs BC3 and BC4 in Paper 2(vi) achieve the improvements they were aiming for.

Title

9 Again to clarify that the Interpretation applies only to customer loyalty award credits granted along with the sale of other goods or services, the IFRIC asked the staff to consider changing its title. The title of D20—*Customer Loyalty Programmes*—implied that it applied to all types of, and aspects of accounting for, customer loyalty programmes.

10 A title that more precisely reflects the transactions within the scope of the Interpretation would be something like:

> IFRIC X *Customer loyalty award credits granted with the sale of other goods or services*

A title like this one would provide a clear and early signal to readers that the Interpretation is addressing only one specific type of transaction arising from customer loyalty programmes.

11 However, a long title impairs the readability of any text that cites it, and is more difficult to recall. Arguably the purpose of the title is only to help readers find the Interpretation among the other Standards and Interpretations in issue. They will read the Interpretation itself to determine the scope. There are other

Interpretations—such as IFRIC 12 *Service Concession Arrangements*—that do not apply to all transactions covered by the title.

12 The staff will recommend retaining the D20 title.

Question for the IFRIC

13 IFRIC members will be asked whether they agree that the D20 title should be retained.

Distinguishing award credits from marketing expenses

14 At the January meeting, the IFRIC asked the staff to explain in the Basis for Conclusions the difference between award credits (within the scope of the Interpretation) and marketing expenses. The aim was to counter views that there is no difference, and hence that the award credits should be accounted for as marketing expenses incurred to secure the sale of the other goods and services.

15 The Basis for Conclusions in D20 did include a reference to the difference. The staff will recommend expanding the explanation as follows:

> BC6 … In support of [the separate component approach], it is argued that:
>
> (a) award credits <u>granted to a customer as a result of a sales transaction</u> are an element of <u>the sales transaction itself, ie</u> the market exchange of economic benefits between the entity and the customer. They represent rights granted to a customer, for which the customer is implicitly paying. They can be distinguished from marketing expenses because they are granted to the customer as part of the sales transaction. <u>Marketing expenses, in contrast, are incurred independently of the sales transactions they are designed to secure.</u>

Question for the IFRIC

16 IFRIC members will be asked whether they are happy with the additional explanation.

Cost/benefit considerations

17 A number of those commenting on D20 argued that the separate component approach proposed was more complicated to implement than the cost accrual approach used by most entities at present. They also argued that it did not produce more useful information, and hence that the costs of the approach exceeded the benefits.

18 At the January meeting, the staff put forward arguments to counter these views and the IFRIC decided to summarise them in the Basis for Conclusions. The staff have drafted additional text in the revised draft Interpretation. (Paper 2(vi), omitted from observer note.)

Question for the IFRIC

19 IFRIC members will be asked whether they are happy with the new text.

Other revisions to Interpretation

20 The revised draft Interpretation (Paper 2(vi), omitted from observer note) includes a number of other more minor changes. These have not been discussed in any of the IFRIC papers, but are explained in comment boxes on the draft. They will not be discussed unless raised for discussion by an IFRIC member.