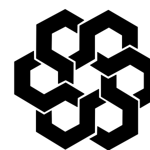

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: www.iasb.org

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: **May 2007, London**

Project: **IAS 18 Customer loyalty programmes (Agenda Paper 2)**

A Introduction

1 At its January and March 2007 meetings, the IFRIC considered comments received on draft Interpretation D20 *Customer Loyalty Programmes*. It decided to proceed to a final Interpretation based on the proposed requirements, but to change some of the details in the light of comments received.

2 A revised draft Interpretation has been prepared—Paper 2(i) [not included in Observer Note].

3 The aim of this meeting is to:

a) resolve one outstanding issue, which concerns the method of allocation of consideration to award credits (Section B);

b) approve the drafting of changes decided upon at the last meeting (in particular, those discussed in Sections C-D);

c) consider the need for re-exposure (Section E);

d) if not re-exposing, confirm the effective date (Section F); and

e) approve the Interpretation (Section G).

B Allocation of consideration to award credits

Background

4 D20 proposed that:

> 5 … The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the components, ie the goods and services sold and the award credits granted.
>
> 6 The allocation shall be made by reference to the <u>relative fair values of the components</u>, ie the amounts for which each component could be sold separately. (emphasis added)

5 Suppose that a grocery store granted loyalty points that entitled customers spending \$100 on groceries to \$1 off future purchases of groceries. Suppose that, taking account of expected forfeiture rates, the store estimated the fair value of the points to be \$0.95 each. The amount of consideration allocated to the award credits applying the relative fair value method would be:

$\$100 \times \$0.95 / (\$100 + \$0.95) = \$0.94$

6 The IFRIC proposed the 'relative fair value' allocation method in D20 on the grounds that it best fulfilled the requirement in IAS 18 *Revenue* for revenue to be measured at the fair value of the consideration received or receivable from the customer.

7 However, as reported at the last IFRIC meeting, some commentators suggested that the Interpretation should not prescribe this method[1]. It should instead require or permit a 'residual' method, whereby the amount of consideration allocated to the undelivered items (ie the award credits) is equal to their fair value, ie $0.95 in this example[2].

8 In support of permitting the residual method for customer loyalty award credits, it can be argued that:

a) it is simpler to apply, because it requires measurement of the fair values of the award credits only. In contrast, the relative fair value method also requires account to be taken of the fair values of the other goods or services sold—so the amount of revenue allocated to award credits varies if the award credits are granted with goods or services of differing values.

b) because award credits are typically a very small component of the sale with which they are granted, the amount of consideration allocated to them is very similar whether the residual or relative fair value method is applied. In the above example, the difference on a $100.00 sale is only $0.01. The residual method could therefore be justified on cost/benefit grounds.

c) Example 11 in the Appendix accompanying IAS 18 discusses a multiple-component sale and suggests that the amount of revenue attributed to the undelivered component would be measured using a residual value method[3].

---

1 IFRIC March 2007, Agenda Paper 2(i), paragraphs 6 to 18.

2 The term 'residual method' is used in US EITF Abstract 00-21 *Accounting for Revenue Arrangements with Multiple Deliverables*. EITF 00-21 defines the residual method as one in which the revenue attributed to the undelivered items is equal to their fair value, and the amount therefore recognised (ie for the delivered items) is the residual consideration received. EITF 00-21 permits the residual method only if there is no objective and reliable evidence of the fair value of the delivered items. In general, it requires the relative fair value method.

3 The estimation technique discussed (cost plus reasonable profit margin) can be viewed as one that aims to measure the fair value of the undelivered component.

9 The IFRIC considered these arguments. Some members favoured retaining the requirement for the relative fair value method, on the basis that this method was the only one that could be defended as being consistent with the measurement objectives of IAS 18, and that other methods might be open to abuse. It was also suggested that the IFRIC need not be constrained by the Appendix to IAS 18. This Appendix is not part of IAS 18 and need not be treated as a framework for the development of Interpretations. The IFRIC should seek to interpret the requirements of IAS 18 itself, which point to a relative fair value method

10 However, other members expressed support for relaxing the requirement, to permit the use of the residual method, if the new requirements:

a) did not preclude the use of the relative fair value method; and

b) clearly prohibited allocations based on either (i) the incremental cost of supplying the awards; or (ii) a 'reverse residual method', in which the revenue recognised for the goods and services already delivered is based on their fair value, and only any residual amount is allocated to the award credits. Applying a reverse residual method, the consideration allocated to award credits could be zero[4].

11 The staff were asked to consider these suggestions and develop recommendations.

Staff analysis

Option A: relaxed requirements

12 If the IFRIC wishes to relax the requirements themselves, the staff will suggest the following wording, which we think would neither risk abuse nor preclude the relative fair value method:

> 6 The consideration allocated to the award credits shall be measured by reference to their fair value, ie the amount for which they could be sold separately.

4 The fair value of the other goods and services would be the price for which they would be sold to customers who did not claim award credits. Typically, this would be the same amount as the consideration received, because award credits are typically granted 'free'.

13 [Consequential draft text for Basis for Conclusions omitted from Observer Note.]

14 However, a possible concern about relaxing the requirements in this way is that the consensus would then appear to endorse the residual method in general—only by reading the Basis for Conclusions would a reader understand that the residual method has been justified on cost/benefit grounds. There is a risk that the Interpretation will be seen as precedent, encouraging the use of the residual method for multiple-component transactions more generally.

Option B: application guidance

15 An alternative option, which would avoid this risk, would be to continue to prescribe the relative fair value method in the consensus but add application guidance explaining that the fair values of the award credits may provide an acceptable substitute:

Allocating consideration - relative fair values

AG4 The fair values of award credits are often very low relative to the fair values of the goods or services with which they are granted. If this is the case, the amount of consideration allocated to the award credits using the relative fair value method is likely to be little different from the fair values of the award credits themselves. Hence, the fair value of the award credits may serve as an acceptable measure of the amount of consideration that should be allocated to them.

Staff conclusions and recommendations

16 The staff have identified three options:

- OPTION A: relax the requirements to permit use of either residual or relative fair value allocation methods.
- OPTION B: continue to prescribe the relative fair value method in the consensus, but add application guidance explaining that the fair value of the award credits may serve as an acceptable measure of the amount of consideration that should be allocated to them.
- OPTION C: make no changes to D20. Continue to prescribe the relative fair value method, making no reference at all to acceptable substitutes.

17 The staff will recommend option B.

Questions for the IFRIC

18 IFRIC members will be asked whether they support Option B.

19 If the IFRIC approves Option B, members will be asked whether they are happy with the wording of the proposed application guidance (in the box following paragraph 15).

C Awards supplied by third parties

Amendments resulting from March decision

20 At the March meeting, the IFRIC decided to amend the consensus to (a) highlight that the entity may be collecting the consideration allocated to award credits as an agent for the third party supplying awards; and (b) explain the consequences for measurement and recognition of revenue if this is the case. The IFRIC approved text for inclusion in the consensus.

21 The staff have added this text to the consensus, but have also suggested further changes:

a) *to explain the revised requirements in the Basis for Conclusions.* New text is proposed in Paper 2(i) to explain the new requirements (BC16 and BC17) and the reason for changing D20 (BC18(a)).

b) *to slightly amend the revenue recognition requirements.* Paragraph BC17 of the Basis for Conclusions explains that the entity recognises revenue when it provides its agency services to the third party. It concludes that these services are provided when the third party assumes the obligation to supply awards and the entity becomes obliged to pass on consideration to it. These events will probably occur at the same time, but only the third party's assuming the obligation was mentioned in the consensus text proposed at last meeting. The staff will suggest also adding "<u>and the entity becomes obliged to pass on consideration to it</u>" to paragraph 8(b) of the consensus.

c) *to reorganise the consensus.* The staff will suggest deleting the old note explaining that third parties can assume obligations to supply awards at different times (old paragraph 9) and adding a shorter version of it into new paragraph 8(b). The staff think that this note can be shortened because there is also now an example illustrating the point it makes in the Illustrative Examples, and the consensus flows better if the note is placed adjacent to the requirement to which it specifically relates.

22 IFRIC members will be asked whether they are happy with these suggested amendments.

Illustrative example

23 At the March meeting, the IFRIC decided to add an example illustrating the application of the revenue recognition requirements when awards are supplied by a third party.

24 The IFRIC discussed a possible example at that meeting[5]. In the example, a retailer granted air miles that customers could redeem for air travel with a specified airline. The airline assumed the obligation to supply awards immediately, so the retailer recognised its revenue from the air miles immediately. The example then illustrated how, depending on whether the entity was judged to be collecting the consideration on its own account or on behalf of the airline, the entity would measure its revenue either as the gross consideration allocated to the air miles or net of the amount payable to the airline.

25 The IFRIC approved this example, and specifically decided to illustrate both gross and net measurement.

---

[5] IFRIC March 2007, Agenda Paper 2(iii), paragraph 6.

26 However, the staff think that the example will need to be amended to reflect revisions to the consensus relating to awards supplied by a third party.

27 So the staff will recommend that only net measurement should be illustrated in this example and have modified it accordingly.

28 IFRIC members will be asked whether they agree with the modifications.

D Other changes requested at March meeting

Guidance on changes in accounting policy

29 At the March meeting the IFRIC decided not to include any specific transitional arrangements in the Interpretation. Hence, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* any changes in accounting policy will be accounted for retrospectively (except to the extent that full retrospective application is not practicable).

30 The IFRIC also decided to clarify in the Interpretation that entities that had previously accrued the costs of supplying awards would be changing an accounting policy, rather than an estimate, when they first applied the Interpretation.

31 The staff have added a note to this effect to the revised draft Interpretation. However, the staff question whether the note is necessary.

32 The staff will therefore recommend that the IFRIC considers deleting it.

33 IFRIC members will be asked for their views.

Other changes

34 Other changes requested at the March IFRIC meeting are marked on the draft Interpretation and explained in an Appendix to Paper 2. [The Appendix has been omitted from the Observer Note.] None of these changes will be discussed at this meeting, unless raised for discussion by an IFRIC member.

35 IFRIC members will be asked whether they have identified any other matters that they think need to be discussed in the meeting.

E Re-exposure

36 The *Due Process Handbook for the IFRIC* states that:

> 40 If the proposed Interpretation is changed significantly, the IFRIC will consider whether it should be re-exposed. Re-exposure is not required automatically and will depend on the significance of the changes contemplated, whether they were raised in the Basis for Conclusions on the draft Interpretation or in questions posed by the IFRIC, their significance for practice and what might be learned by the IFRIC from re-exposure.

37 The draft Interpretation has been altered in two significant respects since it was exposed for comment as D20:

a) *awards provided by a third party.* The Interpretation now highlights the possibility that the entity has collected consideration allocated to award credits on behalf of the third party that supplies the awards. It also explains the consequences, ie that revenue is measured net and recognised as soon as the third party assumes the obligation to supply the awards and the entity becomes liable to pass on the consideration it.

b) *illustrative examples.* Two examples illustrating the application of the revenue recognition paragraphs of the consensus now accompany the Interpretation.

38 Although they do not change the requirements themselves, these additions both highlight consequences of the requirements that some constituents may not have understood when commenting on the draft Interpretation.

39 However:

a) *awards supplied by third parties*. The need to consider whether the entity should measure revenue gross or net had been discussed in the Basis for Conclusions of D20, and was picked up on by a number of commentators. None of them disputed the IFRIC's conclusions, but rather suggested that they should be highlighted more explicitly in the consensus itself. The change to the consensus responds to this suggestion.

b) *illustrative examples*. The illustrative examples have also been added in response to requests for more guidance (especially to address forfeiture and changes in expectations) from a large number of commentators.

Staff recommendation and question for the IFRIC

40 The staff will recommend that the Interpretation is not re-exposed.

41 IFRIC members will be asked whether they agree.

F Effective date

42 At the March meeting, the IFRIC considered requests for a longer lead-in time for the Interpretation than the usual three months. Commentators had suggested that some entities would need more time to complete the systems changes required to change their accounting policies and gather the information required for retrospective application. The staff recommended a lead-in time of six months.

43 The IFRIC did not reach a decision on the effective date but:

a) rejected the possibility of an even longer lead-in time, of 9 months; and

b) decided to warn constituents via the March IFRIC *Update* that it was likely that the Interpretation would be issued in time for it to be effective for financial years beginning on or after 1 January 2008 at the latest.

44 If the Interpretation is approved by the IFRIC at this meeting, it is likely that it will be issued in late June or early July.

45 The staff will recommend that the Interpretation should be effective for accounting periods beginning on or after 1 January 2008, ie giving a 6-month lead in period.

46 IFRIC members will be asked whether they agree.

G Vote to confirm consensus

47 If no substantial issues arise from the matters discussed above, the IFRIC will be asked to vote to confirm the consensus at this meeting. If no more than three members vote against the proposal, the Interpretation will be put the IASB for ratification at its June meeting.