IFRS

STAFF PAPER

27 January 2015

IFRS Interpretations Committee Meeting

Project	**IAS 32 *Financial Instruments: Presentation***		
Paper topic	Classification of liability for schemes similar to prepaid cards issued by a Bank		
CONTACT(S)	Raghava Tirumala	rtirumala@ifrs.org	+44 (0)20 7246 6953

Background and purpose

1. The IFRS Interpretations Committee ('Interpretations Committee') received a request to clarify the classification of the liability for prepaid cards issued by a Bank in the Bank's financial statements and accounting for the unspent balance of the prepaid cards with the following features.[1]
   (a) no expiry date;
   (b) cannot be refunded, redeemed or exchanged for cash;
   (c) redeemable for goods or services only at selected merchants and, depending upon the card programme, ranges from a single merchant to all merchants that accept a specific card network; and
   (d) no inactive balance charges, which means that the balance on the prepaid card does not reduce unless spent by the holder.
2. The submitter asks whether the liability for the prepaid cards issued by a Bank is a financial liability or a non-financial liability of the Bank.

[1] In this paper, references to a 'Bank' should be read to include any financial institution and references to prepaid card(s) should be read as prepaid card(s) with the features as explained in paragraph 1 of this paper unless described otherwise.

3. In its November 2014 meeting, the Interpretations Committee discussed the questions raised by the submitter and observed that:[2]

   (a) the prepaid cards would meet the definition of a financial instrument; and

   (b) the liability for such cards is a financial liability of the issuing bank because the issuing bank has a contractual obligation to deliver cash to the merchant that is conditional upon the cardholder using the prepaid card to purchase goods or services

   In such a circumstance an issuing bank would apply IFRS 9 *Financial Instruments* (IAS 39 *Financial Instruments: Recognition and Measurement*) to determine when to derecognise the liability for prepaid cards.

4. However, the Interpretations Committee noted the similarity between prepaid cards and other arrangements, such as customer loyalty programmes or prepaid cards issued by a non-banking entity that can be redeemed for goods or services of the issuing entity or of other entities. The Interpretations Committee therefore requested the staff to analyse those other similar arrangements and to consider the basis for distinction between the prepaid cards and those other similar arrangements.

5. The purpose of this paper is to analyse other arrangements similar to the prepaid cards described in the submission and understand the basis for distinction.

Staff analysis and recommendations

6. For the purpose of the analysis, we have mainly referred to the definitions of a financial instrument, a financial asset and a financial liability in paragraph 11 of IAS 32 *Financial Instruments: Presentation*.

   > A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

[2] Click here for agenda paper 13 of the November 2014 Interpretations Committee meeting.

A financial asset is any asset that is:

(a) cash

(b) …

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) …

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) …

7. Further, paragraph 19 of IAS 32 states that:

If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability… For example:

(a) …

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

8. We think that an issuing entity should analyse the contractual arrangements between the various parties involved and ascertain the nature of its promises and obligations in determining the classification of its liability. In its assessment of the contractual arrangements, the issuing entity should ascertain if its promise is to provide a payment mechanism, or to provide goods or services. This assessment is even more important if the issuing entity and the entity that transfers the goods or services are not the same. In those situations it is necessary to understand the contractual arrangement between the issuing entity and the entity that transfers the goods or services to determine if the issuing entity is the primary obligor to provide the goods or services.

9. Further, the nature of the obligation of the issuing entity could change over the duration of the contract depending upon the terms and conditions.

10. The analysis in this paper is restricted to the assessment of whether the liability of issuing entity is a financial liability or not. In our assessment, we have relied on the definition of a financial instrument, ie whether the contractual arrangement gives rise to a financial asset of one entity and a financial liability (or equity instrument) of another entity.

11. We have considered some examples of similar arrangements and analysed the nature of the liability of the issuing entity.

Example 1—Prepaid cards issued by a retailer

12. An entity that operates a chain of retail stores has a prepaid gift card programme. The entity issues gift cards of different denominations in exchange for cash from the customers. These gift cards can be used only for buying goods in the stores operated by the entity. The cards cannot be exchanged for cash.

13. In our view, the prepaid gift card issued by the entity is not a financial instrument. The entity does not have a contractual obligation to deliver cash to the holder or another entity. The entity satisfies its obligation by transferring goods to the holder of the prepaid card. Consequently, the entity's liability for prepaid cards is not a financial liability.

Example 2—Prepaid cards issued by an entity that manages shopping centres

14. An entity owns a shopping centre property and manages it. The store spaces are let out to various merchants. The entity has a prepaid gift card programme.

    (a) The entity issues gift cards of different denominations in exchange for cash from customers.

    (b) The cards can be used immediately and cannot be exchanged for cash.

    (c) The cards are accepted by all merchants in the shopping centre as a credit card with preloaded credit.

    (d) The entity has no responsibility for the delivery or quality of the goods or services purchased using the gift card.

    (e) The contractual arrangement between the entity and the merchants is that the entity will pay cash to the merchants each time the card is accepted as payment for the goods or services purchased by the cardholder.

15. Similar to our analysis of the prepaid cards issued by a bank, we think that the prepaid card issued by the entity is a financial instrument. The entity has a contractual obligation to pay cash to the merchants that is conditional upon the cardholder using the card to purchase goods or services from the merchants. The entity's obligation is neither to deliver goods or services nor to oblige the merchants stand ready to transfer goods or services. Consequently, the liability of the entity for the prepaid cards is a financial liability, which has a demand feature because the card can be used anytime by the holder.

16. The card is a financial asset of the holder because the holder has the right to use the card to settle a financial liability, ie liability to the merchants on purchase of goods or services.

Example 3—Customer loyalty programme (awards supplied by the entity)

17. An entity has a customer loyalty programme that rewards a customer with loyalty points for every purchase at a certain ratio. Each point is redeemable for a stated discount on any future purchases of the entity's products.

18. The entity's obligation for the issued loyalty points is to provide goods or services and not to pay cash to the customer. Consequently, we think that the entity's liability for the loyalty points is not a financial liability.

Example 4—Customer loyalty programme (awards supplied by a third party)

19. An entity that owns and operates hotels participates in a customer loyalty programme operated by an airline company. It grants its customers with air travel points for every stay at the hotel. The customer can redeem the air travel points for air travel with the airline subject to the terms and conditions of the loyalty programme. The entity pays the airline a fixed amount per air travel point granted to the customer.

20. The entity's obligation to the customer is fulfilled when it grants the air travel points to the customer. The entity will have an obligation to pay cash to the airline, which is a financial liability.

Example 5—Customer loyalty programme (participating in a loyalty card scheme)

21. Entity X operates a loyalty programme. Entity X is unrelated to any of the entities that participate in the loyalty programme. An entity that participates in the loyalty programme can be either:

    (a) a sponsoring entity, ie entities through whom loyalty points are earned;

    (b) a supplying entity, ie entities with which customers can redeem loyalty points in exchange for goods or services; or

    (c) both a sponsoring and supplying entity.

22. Entity X grants loyalty points to a customer for purchases from the sponsoring entities. Sponsoring entities determine the transactions on which points can be earned and the number of points to be granted. Entities can join or leave the loyalty programme any time without any obligation in respect of the unredeemed loyalty points.

23. Entity X provides a catalogue (website) of goods or services offered by the supplying entities for customers to choose to redeem the loyalty points. The goods or services on offer could change. Entity X is not responsible for delivery of the goods or services or the failure of the supplying entities to make any specific good or service available.

24. On issue of loyalty points, a sponsoring entity pays Entity X a fixed amount per loyalty point rewarded to the customer. On redemption of loyalty points, a supplying entity receives compensating cash from Entity X at a fixed amount per loyalty point redeemed.

25. We think that the substance of the arrangement is that of a payment mechanism. The loyalty points that are issued through the scheme are used like a currency. The accounting for the loyalty points by each of the entities is as follows:

    (a) *Entity X*. Once loyalty points have been granted, Entity X has a right to receive cash from the sponsoring entity, ie a financial asset, and an obligation to pay cash to a supplying entity, ie a financial liability, following the redemption of the loyalty points by the customer for goods or services. Although the obligation to pay cash to a supplying entity is dependent on the customer using the points to purchase goods or services offered by the supplying entities, these actions by the customer and the supplying entity are outside the control of Entity X. Consequently, we think that Entity X has a financial liability from the moment that loyalty points are granted.

    (b) *Sponsoring entities*. Having paid Entity X, a sponsoring entity has fulfilled its obligation to the customer. Until the time the sponsoring entity pays Entity X for the loyalty points granted to the customer, we think that the sponsoring entity has an obligation to pay cash, ie a financial liability.

(c) *Supplying entities*. Having transferred the goods or services in exchange for the loyalty points, the supplying entity has a right to receive cash from Entity X, ie a financial asset, until Entity X compensates the entity.

Staff conclusion

26. We think that entities will be able to reach an appropriate conclusion on the classification of the liability after having considered the contractual arrangements and the nature of the obligation. As explained in paragraph 8 of this paper, an entity should ascertain if its promise is to provide a payment mechanism, or to provide goods or services. The entity should consider the substance of the arrangement in order to answer this question. We think that the guidance in the Standards allows entities to reach appropriate conclusions.

27. On the basis of the above analysis, we made certain edits to the proposed wording of the tentative agenda. The revised proposed wording for the tentative agenda decision is set out in the *Appendix*.

Questions to the Interpretations Committee
1. Does the Interpretations Committee agree with the staff analysis?
2. Does the Interpretations Committee have any comments on the drafting of the tentative agenda decision?

Update of the discussions on the issue at the Financial Accounting Standards Board (FASB) of the United States

28. FASB discussed the submission at its meeting on 5 November 2014 and added the issue to the agenda of Emerging Issues Task Force. The issue identified by the FASB is whether and when should an entity derecognise a prepaid card liability that exists before redemption of the card at a third-party merchant. The issue

relates to prepaid cards that may be redeemed only for goods and services at a third-party merchant and does not relate to arrangements in which prepaid card issuer directly provides goods or services to a card holder or prepaid cards that are refundable or redeemable for cash. The Emerging Issues Task Force of the FASB is yet to discuss the issue.

Appendix

Tentative agenda decision

A1. We propose the following revised wording for the tentative agenda decision.

IAS 32 *Financial Instruments: Presentation*—classification of liability for prepaid cards issued by a bank in the bank's financial statements

The Interpretations Committee received a request to clarify the classification of the liability for prepaid cards issued by a bank in the bank's financial statements and accounting for the unspent balance of the prepaid cards with the following features:

(a) no expiry date;

(b) cannot be refunded, redeemed or exchanged for cash;

(c) redeemable for goods or services only;

(d) redeemable only at selected merchants, and depending upon the card programme, ranges from a single merchant to all merchants that accept a specific card network; and

(e) no back-end fees, which means that the balance on the prepaid card does not reduce unless spent by the holder.

The Interpretations Committee was asked to consider whether the liability for those prepaid cards is a non-financial liability because the issuing bank does not have an obligation to deliver cash to the cardholder.

Based on the responses to the outreach request, the Interpretations Committee observed that the issue is not widespread. The Interpretations Committee also observed that the prepaid cards would meet the definition of a financial instrument, and that the liability of the issuing bank for prepaid cards would meet the definition of a financial liability because the bank has an obligation to deliver cash that is conditional upon the cardholder using the prepaid card to purchase goods or services. Consequently, a bank would apply the guidance in IFRS 9 (IAS 39) to derecognise the liability for prepaid cards.

The Interpretations Committee observed that in the case of prepaid cards and other similar arrangements, eg loyalty programme rewards, an entity issuing the prepaid cards or rewards that can be redeemed for goods or services should consider the substance of the arrangement by analysing the contractual arrangements and assessing whether the entity's obligation is to provide a payment mechanism (leading to a financial liability within the scope of IAS 32 and IFRS 9 (IAS 39)) or to provide goods or services (leading to a non-financial liability).

The Interpretations Committee therefore concluded that in the light of the existing guidance in IAS 32, IAS 37 and IFRS 9 (IAS 39), neither an Interpretation nor an amendment to a Standard was necessary and consequently [decided] not to add this issue to its agenda.