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**International  
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*This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.*

*Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**IFRIC meeting:**                      **July 2006, London**

**Project:**                                **IAS 18 Customer loyalty programmes  
(Agenda papers 2/2(i)/2(ii))**

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## **PAPER 2 — OVERVIEW OF PAPERS**

### *Project status*

- 1     At its last meeting, the IFRIC reached a consensus on how entities should account for award credits (such as loyalty points or air miles) granted to customers in customer loyalty programmes. The consensus was that, applying paragraph 13 of IAS 18, award credits should be treated as a separate component of the initial sales transaction in which they are granted. Hence, some of the consideration received for each initial sale should be allocated to the award credits. This consideration should be recognised as revenue when the customer redeems the credits for awards or a third-party provider assumes the obligation to deliver the awards.
  
- 2     The IFRIC considered the first draft of an Interpretation based on this consensus. It directed the staff to revise aspects of the draft and explore further how the Interpretation should address forfeiture, ie award credits that are never redeemed but are instead allowed to lapse unused by the customer.

### *Aim of this meeting*

- 3 The aim of this meeting is to obtain the IFRIC's approval for the release of the draft Interpretation for public comment.
- 4 The IFRIC will first be asked to approve proposals for addressing forfeiture of award credits, including revisions of estimates — Paper 2(i).
- 5 The IFRIC will also be asked to approve the other revisions to the draft Interpretation. The more significant revisions are explained in Paper 2(ii). A revised draft Interpretation is set out for IFRIC members in Paper 2(iii). [It is omitted from the observer notes.]

## **PAPER 2(i) — FORFEITURE**

### *Introduction*

- 1 Paper 2(i) discusses how entities that operate customer loyalty programmes should account for award credits that are forfeited by customers, ie never redeemed for awards. The paper addresses:
  - a) whether the consideration initially allocated to the award credits should reflect expected forfeiture rates;
  - b) whether and how consideration allocated to credits that are expected to be forfeited should be recognised as revenue; and
  - c) what adjustments would be required if forfeiture rates turned out to be different from those forecast and/or expectations changed regarding future forfeiture rates.
- 2 [Paragraph omitted from observer notes.]
- 3 [Paragraph omitted from observer notes.]

## ***Background***

- 4 The IFRIC has reached a consensus that a selling entity should treat award credits granted to customers as a separate component of the sales transaction(s) in which they are granted (the ‘initial sale’). Hence, some of the customer consideration received at the time of the initial sale should be allocated to the award credits and recognised as revenue when the entity fulfils its obligations in respect of delivery of the awards. If the entity supplies the awards itself, it should recognise the revenue allocated to the awards only when the customer redeems the credits for awards.
- 5 However, some customers never redeem award credits—they may not accumulate the minimum number of credits required to qualify for awards or they may simply choose not to redeem them. The customers in these situations forfeit the credits, allowing them to lapse unused. Forfeiture needs to be taken into account when accounting for award credits.
- 6 IAS 18 *Revenue* does not address forfeiture, which means that different approaches could be adopted. The paper illustrates three approaches and their possible consequences. The staff acknowledges that other versions of each approach could also be developed.
- 7 The approaches are illustrated using a simple example. The example ignores the time value of money and assumes that the total consideration received for the initial sale equals the sum of the fair values of the components, ie that there is no difference which would also need to be allocated amongst the components.
- 8 All approaches start with the proposal in the draft Interpretation that the consideration should be allocated between components by reference to the separate fair values of each component. However, the approaches take different views on the ways in which fair values should be measured.

### *Facts of example*

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| 9  | An entity awards loyalty points to its customers. Each loyalty point can be redeemed further goods or services worth \$1.  |
| 10 | The entity grants 100 loyalty points and forecasts initially that 80% of the points will be redeemed: 40 in the first year and 40 in the second.   |
| 11 | One year later, 45 points have actually been redeemed. The entity revises its estimates and forecast that 90% of the points will be redeemed altogether, ie a further 45 points will be redeemed in the second year. |

### *Approach 1*

#### *Allocation of consideration*

- 12 One approach would be to view the fair values from the perspective of the entity. The entity has a conditional obligation to provide goods or services *if* a claim is made by the customer. Described in this way, the transaction can be viewed as analogous to one in which an entity sells extended warranty cover.
- 13 Applying this approach, the entity would evaluate the fair value of the points by reference to the price it would demand for granting them to customers as part of an initial sale. As with extended warranty agreements, the price would take into account both the value of the goods or services and the likelihood that they will be claimed, ie the forecast redemption rate. Ignoring risk adjustments, the entity would initially allocate consideration of  $\$1 \times 80\% = \$0.80$  to each of the 100 points granted. The total consideration allocated to the points would be \$80.

#### *Revenue recognition*

- 14 The sale of extended warranty agreements also provides a useful analogy for how revenue should be recognised for credit awards that are subject to forfeiture. The seller of extended warranty agreements is providing a service

of warranty cover. Applying paragraph IAS 18, it recognises revenue for providing its service by reference to the stage of completion. The stage of completion could be measured by reference to expiry of the risk of claims. Hence, the pattern of revenue recognition could reflect the expected pattern of claims.

- 15 By analogy, the entity that issues award credits could recognise its revenue by reference to the expiry of risk of points being redeemed, ie in proportion to the expected pattern of redemption of the points. In this example, the points are expected to be redeemed over two years, half in the first year, half in the second. Thus, during Year 1, the entity would release half of the \$80 initially deferred, leaving a deferred revenue liability of \$40.

*Revision of estimates*

- 16 When at the end of Year 1, the entity revised its forecast redemption rate from 80% to 90%, it would not revise the amount of revenue allocated to each point granted in the past: the \$0.80 allocated to each point when it was granted represented the price at which the entity would have sold the points based on its forecasts of redemption rates *at that date*. The selling price would be a historical figure, which would not be updated.
- 17 Neither would the entity revise the amount of deferred revenue to reflect the revised estimate of the number of points yet to be redeemed. The revised estimates still support the initial forecast that points would be redeemed evenly over two years. So the consideration received for delivering awards claimed by customers should still be spread evenly over the two years, ie \$40 in Year 1 and \$40 in Year 2.
- 18 However, because the redemption rate was now forecast to be higher than originally expected the entity's costs would have risen. The entity would need to consider whether the obligation to redeem points had become onerous, ie whether the cost of supplying 45 points worth of awards now expected to be claimed would exceed the \$40 revenue deferred as a liability. If so, any

excess would also need to be recognised as a liability, measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

19 [Paragraph omitted from observer notes.]

20 [ “ ]

## ***Approach 2***

### *Allocation of consideration*

21 An alternative approach would consider the fair value of the point from the perspective of the customer. It would note that, although the entity’s obligations are conditional, the customer’s rights are not—in the example, the customer has an absolute right to claim awards if it wishes to. (In this respect, loyalty award programmes are different from warranty agreements—the rights to claim under warranty agreements are conditional on external events that are outside the control of both the entity and the customer.)

22 It could be argued that the fair value of the customers’ rights (ie the points) is the value of the discount for which they can be redeemed, ie \$1 each. Hence, the consideration allocated to the points should be  $100 \times \$1 = \$100$ .

### *Revenue recognition*

23 Having initially allocated \$100 to award credits, the entity would need to consider how much revenue it should defer. It could be argued that the whole amount should be deferred – the entity should recognise revenue only when it delivers the goods or services (ie customers redeem points) or it is discharged from its obligation to do so (ie points expire).

24 Alternatively, it could be argued that the amount of revenue deferred should take account of expected forfeitures. Only consideration allocated to the points expected to be redeemed should be deferred—the \$20 allocated to points that are expected to be forfeited would be recognised at the time of the

initial sale. Thus only \$80 would be deferred. Of this, \$1 would be recognised as revenue each time a point was redeemed.

#### *Revisions of estimates*

- 25 When \$45 points were actually redeemed in the first year, the entity would recognise revenue of \$45.
- 26 If the entity had initially deferred only \$80 of revenue, it would have a remaining deferred revenue balance of \$35. It could be argued that this balance should be re-measured to \$45, to reflect an increase in the number of outstanding points forecast to be redeemed. The adjustment of \$10 could be offset against the current year's revenue.
- 27 [Paragraph omitted from observer notes.]

### **Approach 3**

- 28 A third possible approach would be a variation on Approach 2. The fair values of the points could be estimated from the perspective of the customer. However, it could be argued that the fair value of the points to a customer depends on whether or not the customer will redeem them: for points that will be redeemed, the fair value is \$1, whilst for points that will not be redeemed, the fair value is \$nil. Said another way, customers who will not redeem points are assumed not to have paid anything for them.
- 29 The entity would therefore forecast that the fair values of the points were  $(80 \times \$1) + (20 \times \text{£nil}) = \$80$ . The entity would allocate this amount of consideration to the points. As points were redeemed, the entity would recognise revenue of \$1 for each point redeemed. There would be no need to account for forfeited points because no revenue would have been allocated to them.

30 When at the end of year 1, the entity revised its forecasts, it could be argued that it should readjust its deferred revenue balance from \$35 to \$45 (as in Approach 2). However, the rationale may be different from that used in Approach 2: it could be argued that the entity would not be re-estimating the number of points for which revenue should be deferred. Rather it would be re-measuring the amount of consideration received for some of these points.

### ***Staff recommendations***

31 [Paragraph omitted from observer notes.]

32 [ “ ]

33 [ “ ]

34 The staff recommends that:

- a) the draft Interpretation should retain its proposal that the fair value of award credits should take into account expected forfeiture rates.
- b) the revenue recognition requirements should be drafted in sufficiently general terms to encompass methods of accounting based on either of Approaches 1 or 3. Either of these approaches would require revenue allocated to award credits to be recognised in the periods in which award credits are redeemed.
- c) there should be no requirement to adjust deferred revenue balances in the light of changes in estimates of forfeiture rates. (The draft Interpretation already proposes that, if the expected costs of fulfilling obligations to supply awards exceed the amount of deferred revenue, a liability is recognised for the excess. This requirement would encompass situations where expected costs increased as a result of changes in forecasts regarding forfeiture.)

- 35 IFRIC members will be asked:
- a) whether they agree that the draft Interpretation should propose that fair values assigned to award credits should take account of expected forfeiture.
  - b) whether they agree with the staff proposal not to develop Approach 1 (and the rationale for it) within the draft Interpretation, but instead to include only general requirements for revenue recognition that would accommodate alternative approaches.
  - c) if they are content with the wording in the draft Interpretation.

## **PAPER 2(ii) — REVISIONS TO DRAFT INTERPRETATION**

### ***Introduction***

- 1 The IFRIC members have received a revised draft Interpretation showing all changes proposed to the version discussed at the May IFRIC meeting.
- 2 Paper 2(ii) highlights and explains the more significant changes. [An appendix to the paper lists and explains the more minor changes. However, this appendix is omitted from the observer notes.]

### ***More significant changes***

#### *Rationale for applying paragraph 13 rather than paragraph 19 of IAS 18*

- 3 The aim of the draft Interpretation is to clarify whether customer loyalty awards should be regarded as a separate component of the initial sale (ie applying paragraph 13 of IAS 18) or a cost that should be provided for at the time of the initial sale (ie applying paragraph 19). At the last meeting, IFRIC members asked the staff to specify more clearly:

- a) *in the 'Issue' section* — that the issue was primarily one of interpreting IAS 18 revenue recognition requirements; and
- b) *in the Basis for Conclusions* — the rationale for the IFRIC's conclusion that paragraph 13 and not paragraph 19 should apply.

4 The issues section has therefore been modified and new text added to the Basis for Conclusions. The new text aims to reflect suggestions put forward by IFRIC members at the last meeting.

5 IFRIC members will be asked whether they are happy with the changes.

### ***Estimates of fair values of award credits***

6 The consensus proposes that revenue should be allocated to the components of the initial sale by reference to their fair values. The previous draft of the Interpretation noted that there may be direct evidence of the fair value of the award credits, for example, if the entity sells them separately or as an optional extra. At the last meeting, an IFRIC member pointed out that the fair values of points sold as optional extras could be different from those granted 'free'—the interpretation should avoid suggesting that they would necessarily be the same.

7 [Paragraph omitted from observer notes.]

8 [Sentence omitted from observer notes.] The staff recommends deleting the reference to award credits sold separately or as an optional extra, thereby retaining only the underlying principles, ie that fair values should be the price at which the entity would sell the goods or services to the customer, taking account of the time value of money etc.

9 IFRIC members will be asked whether they agree with the deletion.

### ***Programmes that offer a choice of awards***

- 10 The first draft of the draft Interpretation did not specifically address loyalty programmes that offer customers a choice of different awards. Several people who reviewed that first draft commented that it was not clear how an entity would account for such programmes, especially if some of the awards were supplied by the entity itself and others by a third-party vendor.
- 11 The staff thinks that the proposed requirements could be applied quite readily to programmes offering a choice of rewards. However, specific guidance would make this point clearer.
- 12 IFRIC members will be asked:
- a) whether they agree that the consensus should specifically address programmes that offer a choice of awards; and
  - b) whether they are happy with the guidance that has been given in the draft Interpretation.

### ***Awards supplied by a third-party provider***

- 13 The previous draft of the Interpretation raised the possibility that, if the entity engaged a third party to supply awards, the entity may be collecting consideration from the customer on behalf of the third party, rather than on its own account, ie in a capacity similar to that of an agent. The draft Interpretation proposed that in such circumstances, the entity should not recognise the gross consideration as its revenue. Rather, it should recognise revenue only for the amount it retained on its own behalf (ie the difference between the consideration received and the amount payable to the third party<sup>1</sup>). It should recognise the net amount when it provided its agency-type services.

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<sup>1</sup> In practice, entities might estimate that the fair values of the award credits are approximately the same as the amount payable to the third party for them—so that there is no net revenue. The amount payable would simply be recognised and offset against the sales proceeds at the time of the initial sale.

- 14 Some IFRIC members did not agree with this suggestion. It was also noted that the general issue of gross or net presentation of revenue is being proposed as a separate agenda project for the IFRIC. The IFRIC therefore decided that the draft Interpretation on customer loyalty programmes should not address the *presentation* issue. The proposals have therefore been deleted from the draft consensus.
- 15 The IFRIC decided that the draft Interpretation should continue to address revenue *recognition* when the entity engages a third party to supply the awards. New text has therefore been added to the draft Interpretation. Aiming to reflect views expressed by IFRIC members at the last meeting, it proposes that revenue should be recognised when either the customer redeems award credits or when a third party assumes the obligation to supply the awards. Further guidance clarifies that whether and when a third party assumes the obligation will depend on the terms of the contract.
- 16 The Basis for Conclusions has also been updated.
- 17 IFRIC members will be asked whether they are satisfied that the new wording appropriately reflects the decision reached at the last IFRIC meeting.

***Publication of draft Interpretation for comment***

- 18 IFRIC members will be asked whether there any other matters that they think should be addressed before the draft Interpretation is published for comment.