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International
Accounting Standards
Board

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: May 2006, London

Project: IAS 18 Customer loyalty programmes (Agenda Paper 3)

Introduction

1 At its last meeting, the IFRIC discussed three ways of accounting for 'points', air miles and other award credits granted to customers in customer loyalty programmes. These were:

A *as a separate component of the initial sales transaction in which the award credits are granted.* Some of the consideration received for each initial sale would be allocated to the award credits. This consideration would be deferred and recognised as revenue when the awards were claimed by the customer or lapsed unused;

B *as an expense incurred in respect of the initial sale.* No revenue would be deferred at the time of an initial sale. Instead, a provision would be recognised for the expected net cost of supplying the awards; or

- C *as A or B depending on the terms of the programme.* The criteria for deciding which accounting treatment to adopt could refer to the relative value or nature of the awards, or the method of supplying them. Approach A would be applied only if, say, the awards were significant in value and/or comprised goods normally sold by the entity in the course of its ordinary activities and/or were supplied by the entity itself (rather than a third-party provider).
- 2 IFRIC members' views were divided. To focus future discussions, the Chairman directed the staff to prepare a paper illustrating how Approach A (the 'separate component' approach) would be set out in a draft Interpretation.
- 3 A draft Interpretation (Paper 3(i)¹) will be presented to IFRIC members. The purpose of the meeting will be to find out whether the IFRIC could support the separate component approach having seen how it would be applied in an Interpretation.
- 4 The rest of this paper explains some features of the draft Interpretation. It does not repeat the rationale for the alternative approaches considered by the IFRIC. These were discussed at the last IFRIC meeting².

Note 1—Scope of the draft Interpretation

- 5 The scope of the draft Interpretation reflects previous IFRIC decisions. It includes sales transactions in which entities grant their customers loyalty award credits that, subject to meeting any further qualifying conditions, the customers can redeem in future for free or discounted goods or services. It is therefore not addressing:
- a) freely-distributed money-off vouchers or other incentives that do not require an initial purchase; or

¹ Not included in the Observer Notes

² March 2006, Agenda Paper 8.

- b) awards that take the form of a cash rebate rather than additional goods or services.
- 6 At previous meetings, IFRIC members raised concerns that the consensus being developed for customer loyalty programmes (then based on Approach C) might wrongly be applied to transactions that were not intended to be within the scope of the Interpretation. Members therefore asked that the boundaries of the scope should be emphasised in the draft Interpretation, with exclusions explicitly identified.
- 7 The new draft Interpretation does not explicitly identify scope exclusions. The reason is that in the staff's view the boundaries of the scope are not so important if the Interpretation is based on the separate component approach. This approach requires an accounting treatment for customer loyalty programmes that, as far as the staff is aware, is consistent with IFRS requirements and practices for similar transactions.
- 8 The staff therefore believes that there is no need to define rigorously the boundaries of the scope or to specify scope exclusions. Indeed, to do so might wrongly imply that the excluded transactions should be accounted for differently.

Note 2—Awards supplied by third-party providers

- 9 Some customer loyalty programmes entitle customers to redeem award credits for goods or services provided by a third party. For example, supermarket customers may be able to redeem supermarket loyalty points for a gift voucher to spend at a clothing store or exchange loyalty points for air miles that they can redeem for flights. The supermarket may pay the clothes retailer or air mile programme operator a fixed amount per voucher or air mile it gives to its customers.
- 10 The reporting entity (the supermarket in this example) may have few, if any, responsibilities in respect of the supply of the awards. The customer may have no recourse to the entity in respect of unredeemed credits. It has been suggested at previous meetings that, in such circumstances, the separate component approach

is inappropriate—the entity should not attribute revenue to goods or services that it has no responsibility to supply, and hence it should not allocate customer consideration to the awards. The loyalty programmes in these circumstances are no more than budgeted expenses, with the third party providing the awards as a service to the entity. So the costs of awards delivered by the third party should be treated as an expense of the initial sale, in accordance with Approach B described in paragraph 1.

11 However, an alternative suggestion was that the separate component approach remains appropriate but the method of applying it may be slightly different. The rationale for this view is that:

- a) the arguments for treating award credits as a separate component of a sale transaction are the same *whoever* supplies the awards. The award credits are an element of the market exchange of economic benefits between the entity and the customer. The customer benefits from—and implicitly pays the entity for—the rights to the awards. The rights are separately identifiable from the other goods or services supplied in the initial sales transaction. They should therefore be accounted for as a separate component of the sale, with part of the consideration being allocated to them.
- b) however, if the entity has no responsibility for supplying the awards, it is in substance collecting the consideration on behalf of the party who has responsibility for doing so—not on its own account. So the entity is acting in a capacity similar to that of an agent for the third-party principal. Paragraph 8 of IAS 18 states that:

Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. ... 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 the commission.

Hence, the entity should not recognise the consideration allocated to the award credits as its revenue. Instead, it should recognise as revenue only the amount it retains on its own account, ie the equivalent of

‘commission’. This amount would be measured by offsetting against the consideration allocated to the credits the amount it has to pay the third-party provider to supply the awards.

- 12 This view reflects conclusions reached by the UK Accounting Standards Board in its Discussion Paper on revenue recognition³. This Discussion Paper developed a model in which customer loyalty points would be accounted for using the separate component approach. The Discussion Paper went on to propose that, if the awards scheme were run by a third party, and this fact were disclosed to the customer, the customer may have no recourse to the entity in respect of unredeemed award credits. The entity’s only liability would be to make the necessary payment to the third-party operator. In such circumstances, it should report its revenue net, as an agent.
- 13 The staff thinks that such an approach would not only affect the presentation of the income and expenses. It would also affect the timing of their recognition. The net revenue recognised by the entity would represent fees for agency-type services rendered to the third-party provider. The entity would recognise this net revenue when it provided its services (often at the time of the initial sale)—it would not defer the revenue until the customer claimed the awards.
- 14 On the basis of the arguments in paragraph 11, the draft Interpretation incorporates a proposal that, if the awards are provided by a third party, the entity should consider whether in substance it is acting as an agent for the third-party provider. If so, it should present income from the award credits net of expenses, and recognise it when it provides the agency services.
- 15 The draft Interpretation does not specify criteria for judging whether the entity is acting as a principal or agent for a third-party provider. The criteria for customer loyalty awards would be the same as those for any transactions in which an entity subcontracts its customer obligations to a third-party.

³ ASB Discussion Paper, *Revenue Recognition*, July 2001, Appendix B--Accounting for ‘points schemes’.

Questions for discussion at the meeting

- 16 IFRIC members will be asked whether they would support a draft Interpretation based on the separate component approach.
- 17 If they would support such an Interpretation, they will be asked:
- a) whether they agree that the draft Interpretation need not list scope exclusions. (Note 1 above)
 - b) whether they agree that, if an entity subcontracts the provision of loyalty awards to a third-party provider, it may in substance be collecting customer consideration on behalf of that provider, and, if so, should recognise revenue net of amounts payable to the provider. (Note 2)
 - c) whether they support the reasons for proposing a separate component approach set out in the draft Interpretation. (Paper 3(i))
 - d) whether they have any other comments on the draft Interpretation.