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IFRIC Illustrative examples

These examples accompany, but are not part of, IFRIC 13.

Example 1—Awards supplied by the entity

IE1 A grocery retailer operates a customer loyalty programme. It grants programme members loyalty points when they spend a specified amount on groceries. Programme members can redeem the points for further groceries. The points have no expiry date. In one period, the entity grants 100 points. Management estimates the fair value of groceries for which each loyalty point can be redeemed as 1.25 currency units (CU1.25). This amount takes into account an estimate of the discount that management expects would otherwise be offered to customers who have not earned award credits from an initial sale. In addition, management expects only 80 of these points to be redeemed. Therefore, the fair value of each point is CU1, being the value of each loyalty point granted of CU1.25 reduced to take into account points not expected to be redeemed ((80 points/100 points) × CU1.25 = CU1). Accordingly, management defers recognition of revenue of CU100.

Year 1

IE2 At the end of the first year, 40 of the points have been redeemed in exchange for groceries, ie half of those expected to be redeemed. The entity recognises revenue of (40 points / 80* points) × CU100 = CU50.

Year 2

IE3 In the second year, management revises its expectations. It now expects 90 points to be redeemed altogether.

IE4 During the second year, 41 points are redeemed, bringing the total number redeemed to 40† + 41 = 81 points. The cumulative revenue that the entity recognises is (81 points / 90‡ points) × CU100 = CU90. The entity has recognised revenue of CU50 in the first year, so it recognises CU40 in the second year.

* Total number of points expected to be redeemed

† Number of points redeemed in year 1

‡ Revised estimate of total number of points expected to be redeemed

Year 3

- IE5 In the third year, a further nine points are redeemed, taking the total number of points redeemed to $81 + 9 = 90$. Management continues to expect that only 90 points will ever be redeemed, ie that no more points will be redeemed after the third year. So the cumulative revenue to date is $(90 \text{ points} / 90^* \text{ points}) \times \text{CU}100 = \text{CU}100$. The entity has already recognised CU90 of revenue (CU50 in the first year and CU40 in the second year). So it recognises the remaining CU10 in the third year. All of the revenue initially deferred has now been recognised.

Example 2—Awards supplied by a third party

- IE6 A retailer of electrical goods participates in a customer loyalty programme operated by an airline. It grants programme members one air travel point with each CU1 they spend on electrical goods. Programme members can redeem the points for air travel with the airline, subject to availability. The retailer pays the airline CU0.009 for each point.
- IE7 In one period, the retailer sells electrical goods for consideration totalling CU1 million. It grants 1 million points.

Allocation of consideration to travel points

- IE8 The retailer estimates that the fair value of a point is CU0.01. It allocates to the points $1 \text{ million} \times \text{CU}0.01 = \text{CU}10,000$ of the consideration it has received from the sales of its electrical goods.

Revenue recognition

- IE9 Having granted the points, the retailer has fulfilled its obligations to the customer. The airline is obliged to supply the awards and entitled to receive consideration for doing so. Therefore the retailer recognises revenue from the points when it sells the electrical goods.

Revenue measurement

- IE10 If the retailer has collected the consideration allocated to the points on its own account, it measures its revenue as the gross CU10,000 allocated to them. It separately recognises the CU9,000 paid or payable to the airline as an expense. If the retailer has collected the consideration on behalf of the airline, ie as an agent for the airline, it measures its revenue as the net amount it retains on its own account. This amount of revenue is the difference between the CU10,000 consideration allocated to the points and the CU9,000 passed on to the airline.

* Total number of points still expected to be redeemed.

IFRIC Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IFRIC 13.

- BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Scope

- BC2 Customer loyalty programmes are widespread, being used by businesses as diverse as supermarkets, airlines, telecommunications operators, hotels and credit card providers. IFRSs lack specific guidance on how entities should account for the awards offered to customers in these programmes. As a result, practices have diverged.
- BC3 The main area of diversity concerns award credits that entities grant to their customers as part of a sales transaction, and that the customers can redeem in the future for free or discounted goods or services. The Interpretation applies to such award credits.
- BC4 In some sales transactions, the entity receives consideration from an intermediate party, rather than directly from the customer to whom it grants the award credits. For example, credit card providers may provide services and grant award credits to credit card holders but receive consideration for doing so from vendors accepting payment by credit card. Such transactions are within the scope of the Interpretation and the wording of the consensus has been drafted to accommodate them.

Issues

- BC5 Different views have emerged about how the entity granting award credits should recognise and measure its obligation to provide free or discounted goods or services if and when customers redeem award credits.
- BC6 One view is that the obligation should be recognised as an expense at the time of the initial sale and be measured by reference to the amount required to settle it, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In support of this view, it is argued that:
- (a) customer loyalty programmes are marketing tools designed to enhance sales volumes. Therefore the costs of the programmes are marketing expenses.

- (b) the value of awards is often insignificant compared with the value of the purchases required to earn them. The obligation to exchange award credits for awards is not a significant element of the sales transaction. Thus, when the initial sale is made, the entity has met the conditions set out in IAS 18 *Revenue* for recognising revenue from that sale. Paragraph 16 of IAS 18 indicates that a selling entity can recognise revenue before it has completed all of the acts required of it under the contract, providing it does not retain the significant risks and rewards of ownership of the goods sold. Paragraph 19 requires expenses relating to the sale, including those for costs still to be incurred, to be recognised at the same time as the revenue.

BC7 A second view is that some of the consideration received in respect of the initial sale should be allocated to the award credits and recognised as a liability until the entity fulfils its obligations to deliver awards to customers. The liability would be measured by reference to the value of the award credits to the customer (not their cost to the entity) and recognised as an allocation of revenue (not an expense). In support of this view, it is argued that:

- (a) award credits granted to a customer as a result of a sales transaction are an element of the transaction itself, ie the market exchange of economic benefits between the entity and the customer. They represent rights granted to the 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. Marketing expenses, in contrast, are incurred independently of the sales transactions they are designed to secure.
- (b) award credits are separately identifiable from the other goods or services sold as part of the initial sale. Paragraph 13 of IAS 18 states that:

The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Because loyalty awards are not delivered to the customer at the same time as the other goods or services, it is necessary to divide the initial sale into components and apply the recognition criteria separately to each component in order to reflect the substance of the transaction.

BC8 A third view is that the accounting should depend on the nature of the customer loyalty programme. The criteria for determining which accounting treatment should be adopted could refer to the relative value or nature of the awards, or the method of supplying them. Award credits would be regarded as marketing expenses if, say, their value were insignificant and/or they were redeemable for goods or services not supplied by the entity in the course of its ordinary activities. In contrast, award credits would be regarded as a separate component of the initial sales transaction if their value were significant and/or they were redeemable for goods or services supplied by the entity in the course of its ordinary activities.

Consensus

Attributing revenue to award credits

- BC9 The consensus reflects the second view, described in paragraph BC7. In reaching its consensus, the IFRIC noted that:
- (a) the first and second views apply different paragraphs of IAS 18. The first view (paragraph BC6) applies paragraph 19 to recognise the cost of the awards at the time of the initial sale. The second view applies paragraph 13 to identify the award credits as a separate component of the initial sale. The issue is to identify which of the two paragraphs should be applied. IAS 18 does not give explicit guidance. However, the aim of IAS 18 is to recognise revenue when, and to the extent that, goods or services have been delivered to a customer. In the IFRIC's view, paragraph 13 applies if a single transaction requires two or more separate goods or services to be delivered at different times; it ensures that revenue for each item is recognised only when that item is delivered. In contrast, paragraph 19 applies only if the entity has to incur further costs directly related to items already delivered, eg to meet warranty claims. In the IFRIC's view, loyalty awards are not costs that directly relate to the goods and services already delivered—rather, they are separate goods or services delivered at a later date.
 - (b) the third view, described in paragraph BC8, would be difficult to justify conceptually. It can be argued that the substance of the incentives is the same, whatever their form or value. A dividing line could lead to inconsistencies and accounting arbitrage. Particular difficulties could arise if a programme offered customers a choice of awards, only some of which would be supplied by the entity in the course of its ordinary activities.
- BC10 The IFRIC considered an objection that the costs of applying the approach set out in the consensus view in paragraph BC7 would exceed the benefits. Those raising the objection argued that:
- the approach is more complicated to apply than a cost accrual approach;
 - it produces information that is less reliable, and no more relevant; and
 - the additional costs are not merited because the amounts involved are often relatively insignificant.
- BC11 The IFRIC acknowledged that entities might have to incur costs to change systems and procedures to comply with the Interpretation. However, it did not agree that the ongoing costs would exceed the benefits. It noted that most of the variables that have to be estimated to measure the revenue attributable to award credits (such as redemption rates, timing of redemption etc) also need to be estimated to measure the future cost of fulfilling the obligation. In the IFRIC's view, benefits to users will arise from customer loyalty award obligations being measured on the same basis as other separately identifiable performance obligations to customers.

Allocation method

- BC12 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 or services sold, using an appropriate allocation method.
- BC13 IAS 18 does not prescribe an allocation method for multiple-component sales. However, its overall objective is to determine the amount the customer is paying for each component, which can be estimated by drawing on the entity's experience of transactions with similar customers. Hence, the Interpretation requires the consideration allocated to award credits to be measured by reference to their fair value.
- BC14 The Interpretation does not specify whether the amount allocated to the award credits should be:
- (a) equal to their fair value (irrespective of the fair values of the other components); or
 - (b) a proportion of the total consideration based on the fair value of the award credits relative to the fair values of the other components of the sale.

The IFRIC noted that IAS 18 does not specify which of these methods should be applied, or in what circumstances. The IFRIC decided that the Interpretation should not be more prescriptive than IAS 18. The selection of one or other method is therefore left to management's judgement.

Measuring the fair value of award credits

- BC14A In *Improvements to IFRSs* issued in May 2010, the Board addressed unclear wording that could lead to divergent interpretations of the term 'fair value' in the application guidance for IFRIC 13. The Board was made aware that paragraph AG2 could be interpreted to mean that the fair value of award credits is equal to the fair value of redemption awards because the term 'fair value' is used to refer to both the value of the award credits and the value of the awards for which the credits could be redeemed. To address this, the Board amended paragraph AG2 and Example 1 in the illustrative examples. The amendment clarifies that when the fair value of award credits is measured on the basis of the value of the awards for which they could be redeemed, the fair value of the award credits should take account of expected forfeitures as well as the discounts or incentives that would otherwise be offered to customers who have not earned award credits from an initial sale.

Revenue recognition—awards supplied by the entity

- BC15 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. 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 Interpretation requires revenue to be recognised as the risk expires, ie based on the number of award credits that have been redeemed relative to the total number expected to be redeemed.
- BC16 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 (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 in respect of award credits that are redeemed in the period. The change in expectations is thus accounted for as a change in estimate in the period of change and future periods, in accordance with paragraph 36 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
- BC17 A change in expectations regarding redemption rates may also affect the costs the entity expects to incur to supply awards. If estimated redemption rates increase to the extent that the unavoidable costs of supplying awards are expected to exceed the consideration received and receivable for them, the entity has onerous contracts. The Interpretation therefore highlights the requirement of IAS 37 to recognise a liability for the excess.

Revenue recognition—awards supplied by a third party

- BC18 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 travel points 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 retain few, if any, obligations in respect of the supply of the awards. In such circumstances, the customer is still receiving the benefits of—and implicitly paying the entity consideration for—the rights to awards. Hence, consideration should be allocated to the award credits.

BC19 However, the entity may in substance be collecting the consideration on behalf of the third party, ie as an agent for the third party. If so, paragraph 8 of IAS 18 would need to be taken into consideration. This paragraph states that:

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

BC20 Depending on the terms of the agreement between the entity, award credit holders and the third party, the gross consideration attributable to the award credits might not represent revenue for the entity. Rather, the entity's revenue might be only the net amount it retains on its own account, ie the difference between the consideration allocated to the award credits and the amount paid or payable by the entity to the third party for supplying the awards.

BC21 The IFRIC noted that, if the entity is acting as an agent for a third party, its revenue arises from rendering agency services to that third party, not from supplying awards to the award credit holders. The entity should therefore recognise revenue in accordance with paragraph 20 of IAS 18. As the outcome of the transaction can be estimated reliably (the consideration has been received and the amount payable to the third party agreed), revenue is recognised in the periods in which the entity renders its agency services, ie when the third party becomes obliged to supply the awards and entitled to receive consideration for doing so.

Changes from draft Interpretation D20

BC22 A draft of the Interpretation—D20 *Customer Loyalty Programmes*—was published for comment in September 2006. The most significant changes made in the light of comments received relate to:

- (a) *allocation of consideration to award credits.* D20 proposed that consideration should be allocated between award credits and other components of the sale by reference to their relative fair values. The IFRIC accepted suggestions that another allocation method—whereby the award credits are allocated an amount equal to their fair value—could also be consistent with IAS 18, and would be simpler to apply. So, as explained in paragraph BC14, the consensus has been revised to avoid precluding this latter method.
- (b) *awards supplied by a third party.* The consensus in D20 did not refer to the possibility that an entity may have collected consideration on behalf of the third party, and hence that its revenue may need to be measured net of amounts passed on to the third party. However, as some commentators pointed out, awards are often supplied by third parties and so this possibility will often need to be considered for transactions within the scope of the Interpretation. The requirements of IAS 18 in this respect have therefore been added to paragraph 8 of the consensus and are explained in paragraphs BC19–BC21.

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- (c) *customer relationship intangible assets.* Customer loyalty programmes may create or enhance customer relationship intangible assets. The consensus in D20 had pointed out that such assets should be recognised only if the recognition criteria in IAS 38 *Intangible Assets* had been met. The IFRIC accepted that this comment appeared to suggest that there would be circumstances in which intangible assets were recognised, whereas the requirements of IAS 38 were such that recognition was very unlikely. It also decided that the comment was peripheral to the issues being addressed in the Interpretation. It deleted the comment from the consensus.
- (d) *guidance on measuring the fair value of award credits.* Paragraph AG2 explains that the fair value of award credits may be measured by reference to the fair value of the awards for which they could be redeemed, reduced to take into account various factors. The list of factors in D20 had referred to the time value of money. However, the IFRIC accepted suggestions that the effect of the time value of money will often not be material—especially if awards are specified in non-monetary terms—and that it should not therefore be highlighted as a factor that will routinely need to be measured.
- (e) *location of application guidance.* Two paragraphs of the consensus in D20 comprised guidance on how to apply the paragraphs that preceded them. They have been moved to an appendix, and supplemented by additional explanation that had been located in the Basis for Conclusions in D20.
- (f) *illustrative examples.* These have been added to help readers understand how to apply the revenue recognition requirements, especially in relation to forfeited award credits and changes in estimates of forfeiture rates.