

IFRIC 13

Accounting for customer loyalty programmes



Welcome

Customer loyalty programmes have grown more widespread in recent years and are now being offered with all types of product and service purchases. Up until now there has been little guidance on accounting for these programmes. IFRIC 13 Customer Loyalty Programmes has recently been issued by the International Financial Reporting Interpretation Committee. IFRS preparers may need to make substantial changes to their accounting policy for these schemes. This publication, which is written primarily with retail and consumer companies in mind, will help clarify the impact of the interpretation, paving the way for a smooth transition. We trust you will find it useful.



A handwritten signature in black ink that reads "David Mason". The signature is stylized and includes a horizontal line underneath the name.

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Introduction

Why was IFRIC 13 issued?

Customer loyalty programmes are widespread. Retailers, airlines, hotels, telecommunications operators and similar businesses offer many of these incentives to their customers.

Accounting for loyalty programmes has varied, with many companies treating the cost of redeeming award credits as a marketing expense. IFRIC 13 was issued on 28 June 2007 and should eliminate much of this diversity. IFRIC 13 clarifies that loyalty programmes are multiple element arrangements, in which the consideration received for the sale of goods or services (from which awards credits are earned) is allocated to:

- the good or service delivered;
- the award credits that will be redeemed in the future.

The consideration should be allocated to the goods or services and the award credits based on the fair value of the credits. The consideration allocated to the award credits should be presented as “deferred revenue” in the balance sheet.

The following table summarises the impact of IFRIC 13 on common current practice:

	Current practice	IFRIC 13
Income Statement Classification	Deduction of revenue or marketing expense	Deduction of revenue
Balance Sheet Classification	Accrual/provision	Deferred revenue
Measurement	Various but generally at related cost to fulfill the obligation for the company	Fair value to the customer
Recognition of the awards	Various: at grant or at redemption	At redemption

The multiple element approach may be conceptually challenging for those companies that have treated award credits as a marketing cost. Management may believe that the only reason for offering an incentive is to keep customers coming back to the store – therefore a marketing cost. However the accounting is more logical if it is considered from the perspective of the customer, who has bought two items – goods and the rights to future goods at a discount.

This publication explores the accounting for award credits under IFRIC 13 for retailers and illustrates the principles with some examples.

How does the IFRIC affect retailers?

There are many schemes but they generally fall into four basic types:

- Awards that entitle the holder to discounted goods and services in the same store.
- Awards that the holders can use in stores within the same chain, for discounted goods or services.
- More complex arrangements, which include award credits that entitle the holder to discounted goods or services provided by another entity (for example purchases in one store earn air miles).
- Arrangements in which third party organisations provide a service of redeeming awards against a variety of goods or services. See example 4 later.

Impact of the interpretation

Scope

IFRIC 13 applies to all entities that grant award credits as part of a sales transaction, including awards that can be redeemed for goods and services not supplied by the entity. This includes schemes as diverse as those offered by supermarkets, airlines, telecommunications operators, hotels and credit card issuers. The interpretation does not apply to entities that settle awards on behalf of the issuer.

The key to determining the accounting treatment is the link to a sales transaction. IFRIC 13 does not apply to incentives provided at the entrance to the store (for example a voucher for a price reduction) or on the street (for example a price reduction on a particular product) rather than in connection with a sale. However, a voucher attached to a product that can only be purchased as part of the sales transaction is within the scope.

Discount vouchers issued separately from a sales transaction are deducted from revenue when a sale is made and the discount voucher redeemed. Revenue is deferred only when the consideration given entitles the customer to a discount on a future purchase.

IFRIC 13 also clarifies the distinction between items that are adjusted against revenue and marketing expenses. The Basis for Conclusions explains that marketing costs are incurred independently of a sale transaction, so any vouchers, allowances and discounts or other incentives offered to a customer as part of a sales transaction are deducted from revenue. This clarification may impact discussions beyond accounting for incentives.

Accounting for loyalty plans

The consideration is allocated to the different elements of the arrangement using fair values. Deferred revenue might be estimated using just the fair value of the award credits or the relative fair values of the award credits and the goods or services sold. IFRIC 13 does not mandate a specific approach for estimating fair value of an award credit, but requires that it is based on the fair value to the holder, not the cost of redemption to the issuer. The fair value of an individual award credit may be estimated using the discount that the customer would obtain when redeeming the incentive for goods or services. Some customers will not redeem some or all of their award credits. The interpretation requires that the fair value of a population of award credits also takes into consideration the proportion of incentives expected to be redeemed.

Some of the factors that might be included in the determination of the individual fair value include:

Similar discount available to other customers	Value dependent on both what the product is and to whom it is offered. If it is a less popular item, near sell by date then likely to have limited value to the customer.
Similar discount to be offered in the future	If offers on popular products are few and far between they will have a much greater fair value than those offered every year and have little or no impact on the customer.
Similar discounts offered routinely	If a free voucher (not requiring a purchase) is offered at the same time as a similar voucher is given out with sales, the fair value will reduce.

Some award credits have a 'use by' date and therefore a finite life. Any deferred revenue not released previously would be released when the credits expired, although this amount should not be material if expected redemptions have been updated regularly. Award credits that have an indefinite life are more difficult and the issuing entity should estimate the period over which they will be used. The estimate should be revised regularly to ensure that award credits are released in the correct period. Retailers therefore may want to revisit whether indefinite life arrangements are suitable.

Principal or agent?

IFRIC 13 requires an entity issuing award credits to determine whether it is collecting revenue on its own account (as principal in the transaction) or on behalf of the third party (as an agent) when the award credits are redeemed by the third party. When the entity is collecting revenue he earns commission income:

- commission income is the net amount (the difference between the consideration allocated to the incentive and the amount payable to the third party supplying the incentive); and
- commission income should be deferred until the third party is obliged to supply the awards and is entitled to receive consideration for doing so.

When the issuing entity is acting as principal and collecting consideration on its own behalf then revenue should be measured as the gross consideration, although an element of the revenue will clearly need to be deferred. This agent-principal aspect is considered further in Example 4 below.

What data does the company need to collect?

Companies that issue award credits will be required to collect the information necessary to estimate the individual fair value of the award credits and expected redemptions.

So how should the individual fair value be determined? The following list is for illustrative purposes rather than a comprehensive clarification of how individual fair value should be determined.

Type of incentive	Indicative individual fair values
Money off coupon attached to product	Cash value of voucher
Points earned as goods are purchased	Based on value of goods points can buy
Points earned at one store to be used at other stores	Based on value of goods points can buy

Historical information will often provide the best estimate of redemption rate and where records are computerised; there should be sufficient data to make an assessment. However, the assumptions used in complex arrangements may need to be discussed with an actuary.

The estimate might be more difficult with informal arrangements. For example, where a customer holds a card which is stamped every time a coffee is bought (entitling the holder to the 10th cup of coffee free), it is not clear how entities will gather data to support a reliable fair value. The interpretation, however, does not provide any exception for this type of scheme and a method for collecting this data (including the number of award credits that have been issued and not yet redeemed) may need to be established as soon as possible to ensure fair values can be supported, and the accounting entries determined.

Revenue or other income?

The award credits might be redeemed against goods or services not supplied in the normal course of business. There are two aspects to consider:

1. Most companies would not buy or trade goods that are not used in its ordinary course of business, so there is likely to be a third party involved. Hence it will be necessary to determine whether the entity is acting as agent or principal.
2. When there is no third party involved, the guidance in IAS 18 should be applied to determine whether the credit is revenue or other income.

Losses

What happens when an incentive would result in a loss on future sales?

Often if retailers are trying to encourage customers to come to their store, a price reduction voucher will be distributed free of charge and independently of another transaction. When these price reductions are distributed, there is no liability recorded, except where redemption of the incentives will result in products (or services) being sold at a loss. Where a loss will be made, the seller has created an onerous contract, and provision will be made in accordance with IAS 37. When the incentives are redeemed, the seller should recognise revenue at the amount received for the product; that is, after deducting the discount granted on exercise of the vouchers from the normal selling price.

As noted above, free vouchers are not within the scope of IFRIC 13. However, if in the unlikely situation an award credit (within the scope of IFRIC 13) is issued which leads to a loss on sale of the later item, the award credit arrangement would also be accounted for as an onerous contract.

Application date

The interpretation is to be applied to all financial statements beginning on or after 1 July 2008. Consequently, calendar year reporters have 18 months to prepare for the IFRIC. Companies should remember that interim financial statements and the comparatives should reflect IFRIC 13. The interpretation states that changes in accounting policy should be accounted for in accordance with IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. Deferred revenue for the comparative period (relating to incentives) is based on information available at the end of the comparative period.

Brief comparison with US GAAP

The U.S. Financial Accounting Standards Board's Emerging Issues Task Force (EITF) was unsuccessful in developing a model to account for these point and loyalty programmes in its deliberations of EITF 00-22 Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future (EITF 00-22). Of the five issues discussed by the Task Force, Issue 3 (how a vendor should account for an offer to a customer to rebate or refund a specified amount of cash that is redeemable only if the customer completes a specified cumulative level of revenue transactions or remains a customer for a specified period of time), was the only issue in which a consensus was reached and was later codified in EITF 01-9 Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products).

Due to the lack of consensus in EITF 00-22 there remains a divergence in practice in US GAAP for the accounting for loyalty programmes. It is acceptable for companies to account for loyalty programmes as multiple element arrangements using an analogy to EITF 00-21 or to IFRIC 13. In certain circumstances, when the costs of fulfilling the points are inconsequential or perfunctory, the incremental cost model may be appropriate under US GAAP, but using this approach would usually give rise to a reconciling amount for FPIs. Companies should use the appropriate US GAAP literature (for example EITF 01-9) for other types of incentive programmes.

Summary

Accounting practice for customer loyalty plans has been diverse. The issue of IFRIC 13 has now clarified that these arrangements should be accounted for as multiple element arrangements. The interpretation should be applied for periods beginning on or after 1 July 2008, with comparatives being restated. The relatively long implementation period reflects that many corporations will have to make significant systems changes and collect a significant amount of data to comply with the new guidance. Preparers should start immediately to collect information about the various incentives within their organisations and assess the implications on their information needs and accounting.

Appendix:

Examples of practical application of IFRIC 13

Example 1:

Award credits issued by an entity

An entity awards 80 points with each purchase of goods for C100. These points can be exchanged for goods, supplied by the entity. The customer has a three year period over which he/she can use the credits. For every 1,000 points, goods with a retail price of C60 can be obtained. If the entity provides these goods itself its cost is C12. Assume that the entity has awarded 120 of these points in connection with sales of C150 and expects 100 of these points to be redeemed.

The "individual fair value" of the points is C7.2 ($60 \times (120/1000)$). The total fair value of the award, applying the likely redemption rate to the individual fair value, is therefore C6 ($C7.2 \times (100/120)$) being the fair value for the customer of goods obtainable. It is not C1.2 ($12 \times (120/1000) \times (100/120)$) as that is the cost to the entity of providing the goods.

On the initial sale, the fair value of the incentive is deferred being

Dr Cash	C150
Cr Deferred revenue	C6
Cr Revenue	C144

Year 1

At the end of the first year, 50 points have been redeemed. The entity will recognise revenue of $(50/100) \times C6 = C3$ of the total of C6 which has been deferred.

Year 2

During the second year, 10 points have been redeemed, bringing the total redeemed to date to $10+50=60$. Management now expect a total of 90 points to be redeemed. The company should then recognise a revenue of $(60/90) \times C6 = C4$, as C3 has already been recognised, the company recognises a further C1.

Year 3

In the third year, 30 additional points are redeemed or have expired. Consequently, the remaining C2 of deferred revenue is recognised.

Dr Deferred revenue	C2
Cr Revenue	C2

Example 2:

Award credits issued by an entity – incorrect estimate of redemption rate

The facts are the same as example 1; however, by the end of year 3, all the 60 outstanding points have unexpectedly been redeemed. To date C4 of the total C6 deferred revenue has been released, but no more revenue has been received. The allocation of the consideration at the date of the original sale is not revisited. The remaining C2 is released against the 30 expected points as well as the additional 30 points which were not expected as follows. This would indicate that there needs to be a review of the estimation of redemption rates to ensure incorrect estimates are minimised.

Dr Deferred Revenue	C2
Cr Revenue	C2

Example 3

Award credits issued by an entity – identification of individual fair value

A retailer sells a toy for C20. A voucher entitling the bearer to a discount of C6 on a subsequent purchase of the same type of toy is issued with each sale. Another retailer normally sells the toy for C18 without the provision of such a voucher. The retailer has historical experience that for every two vouchers issued, one is redeemed.

The customer is purchasing both the toy and a voucher. Therefore, part of the consideration received should be allocated to the 'money-off' coupon. The revenue should be allocated based on the fair values of the toy and the coupon.

In the absence of other factors, the individual fair value of the voucher would appear to be C4. This is calculated by comparing the normal sales price for the toy (C18), to the price at which a toy can be purchased using the voucher (C14). This value is then adjusted for the proportion of vouchers expected to be redeemed (50 per cent).

The consideration received is equal to the aggregate fair value of the toy and the voucher.

The accounting entry when, say, ten toys are sold and the vouchers are issued is

Dr Cash	C200
Cr Revenue	C180
Cr Deferred revenue	C20

When a single voucher is redeemed the accounting would be as follows:

Dr Deferred revenue	C4
Dr Cash	C14
Cr Revenue	C18

The amount of revenue recognised upon redemption of the voucher is based upon the number of vouchers redeemed relative to the total number expected to be redeemed. Given that only half of all vouchers are expected to be redeemed, revenue of C4 is released on the redemption of each voucher.

Example 4:

Awards supplied by a third party

Company A runs a loyalty card scheme independently from any retailers. Company A has contracts with each retailer; and the retailer can take any one of the following different roles:

- Be an issuer of points
- Be a redeemer of points
- Both issue and redeem points

The customer holds a loyalty point card which is issued by Company A and allows the customer to earn points at a given list of retailers and use points at other retailers.

The face value of the point issued is C1 and for each point issued, the issuing retailers will pay C0.98 to Company A, in doing so earn C0.02 of commission income. Once the issuing retailer has paid Company A it has no further obligation to the customer.

When a retailer redeems points with a face value of C1, it will receive compensating cash from Company A of CU0.91. Company A's margin is the difference between the redemption price and the issue price.

Where a retailer both issues and redeems points, there is no netting of cash flows: cash is paid to Company A for points issued, and cash is received from Company A for points redeemed.

The benefits for the participating retailers are:

- There is no need to administer the scheme
- There is no obligation in respect of outstanding points, and the retailer can exit the scheme
- The fair value for the customer will be higher if the points are redeemable at a variety of stores

The accounting for such a scheme is as follows:

When the retailer makes a sale of C10, it issues points with face value of C1:

Dr Cash	10.00
Cr Revenue	9.00
Cr Commission income	0.02
Cr Liability to A	0.98

When the risks and rewards associated with the points are immediately passed to Company A, the liability is offset:

Dr Liability	0.98
Cr Cash	0.98

When the points are redeemed, the redeeming retailers will recognise the revenue made by the points with a face value of C1 at C0.91:

Dr Receivable from Company A	0.91
Cr Revenue	0.91

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