Corporate Watch

Developments on Corporate Reporting and Governance*
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*connectedthinking

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Contents

Customer loyalty points – a marketing tool that can shave off your revenue line? 3

Do you owe or are you owned? The Debt-Equity puzzle in derivatives 7

Other developments 9

Acronyms

ASC	Accounting Standards Council
FRS	Financial Reporting Standards
IAS	International Accounting Standards
ICAPS	Institute of Certified Public Accountants of Singapore
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
INT FRS	Interpretations of FRS
RAP	Recommended Accounting Practice
SOCI	Statement of Comprehensive Income
SOCE	Statement of Changes in Equity

Customer loyalty points – a marketing tool that can shave off your revenue line?

Almost every one of us holds a variety of loyalty cards that offer us free or discounted goods or services in the future. Supermarkets, petrol stations, departmental stores, bakeries, laundry shops, telephone operators, credit card companies, airlines and hotels make up a long list but these are just some examples. Businesses innovate rapidly in this competitive environment.

How do these customer loyalty schemes affect the financial results of those businesses that own them? Currently, it is common for the businesses to estimate the costs of providing these goods or services in the future and account for them as marketing expenses as soon as the loyalty points are issued to the customers. For example, a Singapore-New York-Singapore round trip air ticket may provide free "air miles" to the customer who can redeem the miles for a Singapore-Hong Kong-Singapore round trip ticket. The customer may pay $10,000 for the ticket with the "air miles". The airline records $10,000 as its revenue and in addition to the cost of provision of the Singapore-New York-Singapore trip, the airline also records the expected cost for the Singapore-Hong Kong-Singapore trip that it expects to incur on the free "air miles". The expected cost for the airline are often the incremental ones (such as cost of the meals) as the airlines typically will only allow redemption by the customer when there is an available seat on an existing flight.

The above treatment will be radically changed with the issuance of Interpretation to Financial Reporting Standard 113 Customers Loyalty Programmes (INT FRS 113) that is effective from financial year commencing 1 July 2008.

Defer recognition of a portion of total consideration to the future

INT FRS 113 views a sale transaction that involves the award of customer loyalty points as a transaction that contains two separately identifiable components (i.e. "multiple-elements"). The loyalty points or awards are separately identifiable from the other products or services sold as part of the initial sale. Accordingly, part of the total sales consideration received from the customer is attributable to products or services which the seller has not delivered.

Using the above example, revenue attributable to the Singapore-Hong Kong-Singapore trip will be deducted from the $10,000 collected from the customer and recognised in the income statement only when the customer utilises the Singapore-Hong Kong-Singapore ticket. This means a reduction in revenue in the period when the initial sale is made.

How much to defer?

INT FRS 113 requires the estimation of the fair value of the loyalty points, i.e. the fair value of the goods and services that can be redeemed in the future using the points. Fair value means the fair value to the customer and not the cost of providing those goods or services to be incurred by the seller.

Again, using our earlier example, the current sale price of the Singapore-Hong Kong-Singapore ticket may be $2,000. Hence, the airline would recognise $8,000 for the initial sale and defer the $2,000 attributable to the second trip. It is not always clear what is the fair value of the "future goods or services" and hence businesses may face challenges in estimating these fair values.

The above example deals with a single sale transaction. INT FRS 113 recognises that not all customers would redeem the loyalty points. Therefore, in the estimation of the fair value of points, a forfeiture discount is allowed in determining the fair value of the points. Companies would have to make an estimation of the forfeiture discount based on its past experience and future expectations. This may not be straight forward.

So, when is the deferred revenue recognised if at all?

INT FRS 113 makes a distinction on whether the seller or a third party is obligated to deliver the goods or services in the future when the customers redeem the points. Whether and when the third party assumes the obligation depends on the terms of the sales agreement the customer has with the seller. In addition, a customer can often choose to redeem the points from either the seller or a third party. The third party would assume the obligation to provide those goods or services only when a customer chooses to claim awards from it.

When the seller has the obligation, INT FRS 113 requires the recognition of the revenue when the goods and services are provided. If a third party assumes the obligation, revenue is recognised by the seller as and when the third party assumes the obligation from the seller. The third party might assume the obligation as soon as the points are granted, in which case, the seller would recognise the revenue at the same time as the initial sale.

Principal or agent? Revenue or other income?

When the seller collects revenue for the points but does not provide the goods or services to the customer on redemption of those points, it may be viewed as acting as an agent of the third party (that will provide the service) rather than the principal. It would be inconsistent under FRS 18 Revenue for the seller to recognise as revenue all of the consideration received for the points in these circumstances. The seller should recognise only difference between the consideration and the cost of supply (commission income), if any, relating to its service as agent to the supplier of the goods and services. For example, points earned from credit card purchases may be redeemable for air tickets or hotel stays. It is likely that the credit card companies are not be the primary obligor of the air travel or hotel stay and hence would not recognise the full fair value of the air ticket or hotel stays. Rather, the credit card companies recognise a commission or fee on the air ticket or hotel stay.

Also, the points may be redeemed for goods or services that are not ordinarily supplied by the seller. In such cases, it may be more appropriate to present the income separately from revenue as other income.

Onerous contracts

The seller may also have to incur costs in excess of the revenue that is attributable to the portion of the goods and services that are to be delivered in the future under the loyalty points. In this case, the seller has an onerous contract. The seller will be required to account for the loss as an additional liability in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Onerous contracts can also occur if the expected costs of supplying the future goods or services increases as a result of revision in expected number of award credits that will be redeemed.

For example, a department store allows its customers to redeem a free toaster for purchases in excess of $500. It allows the customer to redeem over a 3-month period. The fair value and cost of each toaster is $50 and $40 respectively. It expects only eight in 10 customers would redeem the free toaster.

Assume that the department store collected $5,000 from 10 customers. The department store would recognise $4,600 of sales [$5,000 - $50 x 10 x 80%] and defer $400 revenue until the customers redeem the toasters. At the end of the first month, five customers redeemed. Department store thus recognises $250 [$400/8 x 5] as revenue with the related cost of $200 [$40 x 5]. At the end of the second month, three more customers redeem. The store now expects

nine instead of eight customers would redeem the toasters. The store now recognises revenue of $112.50 [($400 - $250)/4 x 3] revenue and the cost of $120. In addition as the cost of supplying ninth toaster in the future amounting of $40 exceeds the future revenue of $37.50, the expected loss of $2.50 [$40 - $37.50] would be recognised at the end of the second month.

Are all types of discount schemes affected?

INT FRS 113 does not affect all types of discount schemes. If a business provides free vouchers that entitle the holders discounted goods in the future, this is not within the scope of the interpretation as there is no initial sale transaction in consideration of the free vouchers.

However, the interpretation includes within its scope, transactions where the grantor of the loyalty points may be different from the seller of the initial goods, for example credit card companies that issue “points” for its card holders’ transactions with a third party vendor.

Implications to businesses

Businesses with extensive customer incentive plans must evaluate their schemes and the arrangements with their partners in the schemes in determining the extent of the financial implications.

The following are key implications that businesses should give serious consideration.

First, the deferral of revenue and profits to a future period. Using the same airline example above, the following table illustrates the financial impact:

	Marginal costs approach (pre- IFRIC 13)		Deferral approach (post IFRIC 13)
Sales	10,000		8,000
Expenses	(2,000)		(2,000)
Marginal costs	(20)		
Net profit	7,980		6,000
Difference		(1,980)	-25%

The financial effect on the bottomline is more pronounced for businesses with large margins or little incremental costs such as the airlines and hotels as much revenue and margin is deferred. Revenue is an item that many analysts and other stakeholders focus on. Hence, any significant effect on it needs to be explained appropriately.

The second implication which is also related to revenue is that the arrangement with suppliers to supply goods that are not ordinarily part of the business of the seller that awarded the loyalty points. The seller may be seen as an agent and even when not as an agent, the consideration that is attributable to the loyalty awards may be considered as “other income” rather than “revenue”. Revenue line may be significantly affected by this.

The third implication is the need for businesses to measure the fair value of the loyalty points as well as the rates of forfeiture. There may be a variety of goods and services that can be redeemed and hence an average fair value may be necessary. Businesses will need systems to help track, analyse and forecast the rates of forfeiture, if any, of the points. Onerous contracts may arise when the rate of redemption is more than the initial estimated rate. Businesses need to consider if they have the required systems and processes to track and identify such cases and then compute the amount of expected loss.

Lastly, businesses should also examine internal and external performance indicators that are evaluated against the revenue line as the interpretation could potentially affect such a key performance measure.

With the impending issuance of INT FRS 113, it’s time that accountants speak to their marketing folks before they put up another scheme to attract and retain customers.

Do you owe or are you owned?
The Debt-Equity puzzle in derivatives

Almost all companies and businesses have debts and equity on their balance sheets. Many of them also issue financial instruments (e.g., shares, preference shares, bonds, options, warrants) that exhibit characteristics of debt or equity or both in the same instrument. Debt/equity classification can be a very tricky issue.

Why is it so important to classify a financial instrument appropriately? Firstly, classification impacts what is computed as net total assets and equity, which in turn affects indicators such as gearing ratio (which may affect borrowing costs) and return on equity (which may be a performance indicator for management). Secondly, debt instruments generally have an impact on the income statement and may create volatility on the bottom line. Equity instruments generally do not have such effects.

So, what is the first principle in debt/equity classification? Looking at the accounting standards, FRS 32 regards a financial instrument as a liability where the issuer of the instrument does not have a right to avoid settlement of the obligation with cash, another financial asset or own equity instrument. For settlement in own equity instrument, the financial liability is also not settled by a fixed number of the equity instruments of the issuer (the "fixed-for-fixed" criterion). If settlement can be in a fixed number of own equity instrument, the instrument may be an equity instrument.

Questions commonly arise with regards to the fixed-for-fixed criterion. Consider the following scenarios:

1. **An option to deliver $1m worth of the issuer's ordinary shares at a future date based on the share price of the ordinary shares at the future date**

   The number of shares deliverable by the issuer is variable as it depends on the share price at the future date. This is a financial liability of a fixed amount that is settled by its own shares of a variable amount, i.e. NOT fixed-to-fixed. The holder of the instrument does not have an equity interest in the issuer as it does not participate in the increase in the value of the shares nor exposed to the downfall of its value before the shares are issued to the holder.

2. **A call option that is settled net in cash, based on the difference between a fixed amount of cash and the market value of a fixed number of the option writer's shares**

   For options that are settled net in cash, the issuer will not deliver any shares. Upon exercise of the option, if the option is in-the-money, the issuer merely pays the option holder, in cash, the difference between the market price and the strike price. Such a derivative that does not require the delivery of equity instruments upon exercise is a financial liability even though the final settlement amount is based on a fixed-for-fixed principle.

3. **A contract that is settled by delivering a fixed number of shares in exchange for a fixed amount of foreign currency (i.e. any currency other than the issuer's functional currency)**

   One view may be that this option satisfies the fixed-for-fixed criterion, since the amount of consideration for the shares is fixed, albeit in a foreign currency. However, this view is not that held by IFRIC that is responsible for interpreting IFRS. IFRIC noted that such a foreign currency obligation represents a variable amount of cash from the viewpoint of the issuer's functional currency. Accordingly, this fails the fixed-for-fixed criterion and the option is a financial liability of the issuer. If the fixed amount is in the functional currency of the issuer, the conversion option will be considered as equity instrument of the issuer.

4. **An option to issue a fixed number of the issuer's shares for a fixed amount in the issuer's functional currency, subject to anti-dilution clauses**

   Anti-dilution clauses are clauses that protect the option holder's rights in a situation which change the value of shares receivable by the option holder even though the underlying value of the issuer has not changed. In this example, the anti-dilution clause may stipulate that in the event of a stock split, the number of shares issued upon exercise will double.

   Although strictly speaking, such an anti-dilutive clause introduces variability into the number of shares issued, the common view is that the clauses is not a violation of the fixed-for-fixed criterion provided, firstly, that the relative rights of the shareholders and option holders are maintained, and secondly, the instrument would otherwise meet the fixed-for-fixed requirement.

The above examples illustrate some of the complexities and issues in the application of the debt/equity principles. Given the rapid proliferation of various terms of financial instruments, we would not be surprised to see further developments in these rules to deal with new situations. This is a complex area of accounting for which you should consult with your accounting advisors when in doubt.

Other developments

A) FRS/INT FRS issued

28 March 2008 – ASC issued the following new accounting standards and interpretations:

FRS 1 (R) – *Presentation of Financial Statements*
INT FRS 114 FRS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their interaction*
INT FRS 113 – *Customer Loyalty Programmes*

Table I provides a brief summary of these standards.

B) Exposure Drafts/Discussion Papers

1. **8 January 2008 – Accounting Standards Council issues the following exposure drafts:**

   a) Proposed amendments to FRS 102 *Share-based Payment and INT FRS 111 - Group and Treasury Share Transactions*

      The proposed amendment addresses the accounting in the separate financial statements of a subsidiary when its suppliers/employees will receive cash payments from the parent that are linked to the price of the equity instruments of an entity in the group. It is the parent, and not the entity, which has the obligation to deliver cash. The proposed amendment to INT FRS 111 specifies that the entity should measure the goods and services received based on a cash-settled share based payment. However, since the entity has no obligation, the corresponding credit would be recorded in equity.

   b) Proposed amendments to FRS 101 *First time adoption of Financial Reporting Standards and FRS 27 Cost of an investment in a subsidiary, jointly controlled entity or associate.*

      FRS 27 requires a parent, in its separate financial statements, to account for an investment in a subsidiary either at cost or at fair value. The amendment to FRS 101 proposes to allow a parent, at its date of transition to IFRSs, to use a deemed cost for an investment in a subsidiary.

      The proposed amendment to FRS 27 proposes to delete the definition of the cost method from FRS 27 (and all associated references). Additionally, dividends received by an investor from a subsidiary, jointly controlled entity or associate are to be recognised as income. The related investment shall be tested for impairment in accordance with FRS 36 *Impairment of Assets.*

2. **25 January 2008 – ICPAS has withdrawn the Statement on Recommended Accounting Practice: RAP 9 *IPO costs*.**
   The withdrawal is effective for annual periods beginning on or after 1 January 2008. Subsequent to the withdrawal, only costs directly attributable to the issue of new shares can be charged to equity. Costs attributable to the sale of existing vendor shares should be charged to the income statement. If costs are incurred both for the issuance of new shares and listing of existing shares, an apportionment of the total costs should be made.

3. **14 February 2008 – ASC has issued Exposure Drafts for the below:**

   a) INT FRS for Distributions of non-cash assets to owners (D23)

      INT FRS D23 proposes that distributions of non-cash assets to owners be measured at the fair value of the assets distributed, with the difference with their carrying amounts being recognised in profit/loss. INT FRS D23 would not apply to distribution of assets to another entity within the same group.

   b) INT FRS for Customer Contributions (D24).

      INT FRS D24, if adopted, will standardise practice and result in increased recognition of property, plant and equipment at fair value with the resulting credit recognised as revenue over the period of supply of goods or services.

4. **ASC invites comments on the following discussion papers issued by IASB:**

   Reducing Complexity in Reporting Financial Instruments (Comments to be received by 1 July 2008)

   Financial Instruments with characteristics of Equity (Comments to be received by 1 July 2008)

   Preliuminary Views on Amendments to IAS 19 Employee Benefits (Comments to be received by 15 August 2008)

Table I

<table>
<tr><th>Standard</th><th>Summary</th></tr>
<tr><td>FRS 1 (R) Presentation of Financial Statements</td><td>Effective for FY commencing 1 January 2009
The revised standard uses “Statement of Financial Position” and “Statement of Cash Flows” for those statements to replace the previous titles”Balance Sheet” and “Cash Flow Statement”.

The revised standard requires:

(i) non-owner changes in equity to be presented in the Statement of Comprehensive Income separately from the Statement of Changes in Equity (SOCE). Income and expenses can either be presented in one statement (a SOCI) or in two statements (a separate income statement and a SOCI).

(ii) requires the disclosure of reclassification adjustments AND income tax relating to each component of other comprehensive income. Reclassification adjustments are the amounts reclassified to profit or loss that were previously recognised in other comprehensive income.

(iii) In addition, entities making restatements or reclassifications of comparative information will be required to present a restated balance sheet as at the beginning of the comparative period.

The key impact of the application of the revised standard is the presentation of an additional primary statement, the statement of comprehensive income.</td></tr>
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Standard	Summary
INT FRS 113 *Customer Loyalty Programmes*	Effective for FY commencing 1 July 2008. This interpretation applies when a company grants award credits to customers as part of a sales transaction which can be redeemed for free or discounted goods. The interpretation provides the following guidance: (i) Allocation of consideration received: This interpretation applies when a company grants award credits to customers as part of a sales transaction which can be redeemed for free or discounted goods. Management shall allocate part of the consideration for such transactions to the award credits based on fair value. (ii) Revenue recognition: When the reporting entity is obligated to supply the goods or services in the future, revenue shall be recognised when the goods/services is delivered/supplied. If the reporting entity is a principal, revenue is recognised when the obligation to supply the future goods/ services is fulfilled. If the reporting entity is an agent, the net amount retained is recognised when the third party becomes obliged to supply future goods/services. (iii) Unavoidable costs: If at any time the unavoidable costs to satisfy award credits exceed the consideration allocated to those credits, management should recognise the excess as a liability for onerous contracts.This could happen, for example, if management revises upwards its estimate of the proportion of award credits expected to be redeemed

Standard	Summary
INT FRS 114 FRS 19 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their interaction*	Effective for FY commencing 1 January 2009. Companies may benefit from surplus position on defined benefit plans (i.e. plan assets exceeding plan liabilities) in that further contributions may be reduced by the surplus. However, defined benefit plans may be subject to minimum funding requirements, thereby impairing the ability of the company to benefit from the surplus position. This will place a maximum limit on the asset that can be recognised in respect of such surpluses ("cap"). This interpretation specifies the considerations in determining the "cap".

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