LOYALTY PROGRAMMES: DEFER REVENUE OR PROVIDE FOR COSTS?

Elmar Venter
Accountancy SA; Dec 2006/Jan 2007; Accounting & Tax Periodicals
pg. 10

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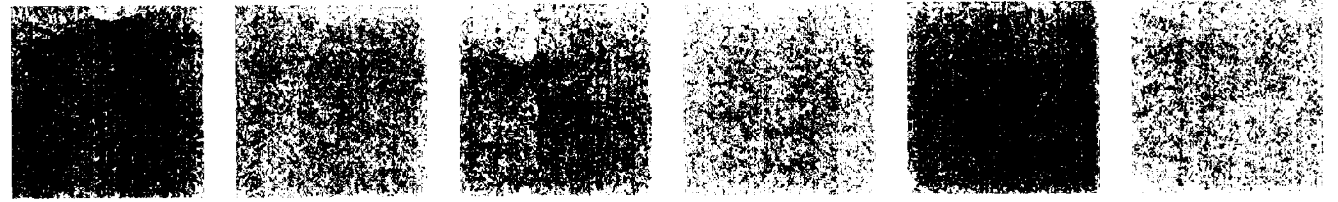
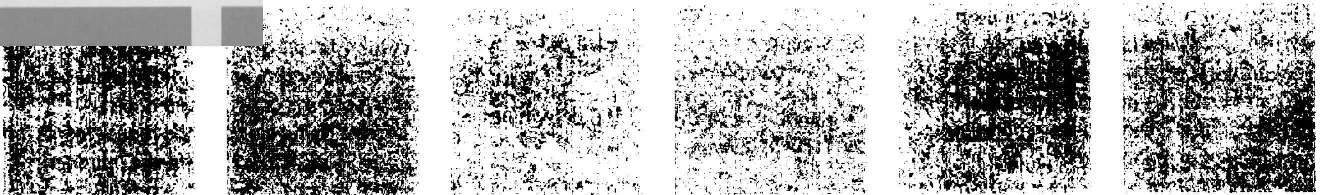


LOYALTY PROGRAMMES:

DEFER REVENUE OR PROVIDE FOR COSTS?

Loyalty programmes have long been an integral part of many entities' incentive and customer relationship management programmes. They are currently used by businesses as diverse as supermarkets, telecommunications entities, airlines, hotels, motor vehicle rental companies, movie houses, music stores, and book sellers.



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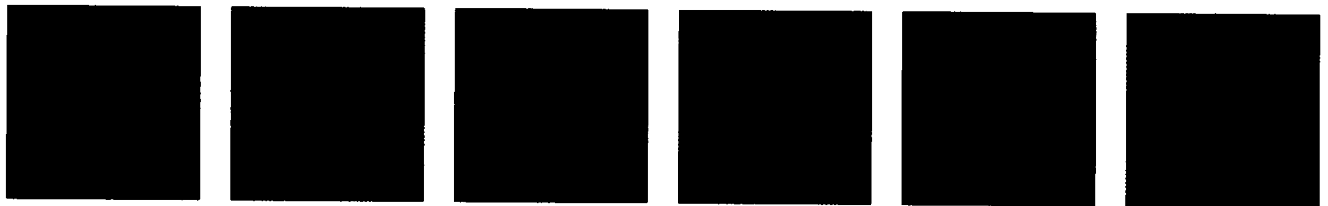

Loyalty programmes are structured in such a way that either a specified volume or a specified number of transactions are required for a customer to earn sufficient credits to receive an award. Each time a customer purchases a product or service, award credits are earned which, subject to specified minimum thresholds, may be redeemed in future in the form of awards such as free or discounted products or services. The purpose of loyalty programmes is to develop a long-standing customer relationship between the supplier and the consumer and to increase sales.

There are the following two opposing views on how loyalty programmes should be accounted for:

- Credits granted to customers in a customer loyalty programme can be accounted for as a separate component of the initial sales transaction in which the award credits are granted (a "multiple elements approach").
- Credits granted to customers in a customer loyalty programme can be accounted for as an expense incurred in respect of the initial sale (a "provision for future cost approach").

This article considers the conceptual justification of these two methods and highlights the work performed by the International Financial Interpretations Committee (IFRIC) in this regard. The implications of the method chosen by the IFRIC are also briefly discussed.

The multiple elements approach

The conceptual arguments for the multiple elements approach

This method is based on paragraph 13 of IAS 18 (AC 111), *Revenue:*

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 (own emphasis added).

In essence, IAS 18 (AC 111) is designed to ensure that revenue is recognised as soon as goods or services have been delivered to a customer. The question is therefore whether a sale which is part of a loyalty programme should be considered a "dual sale", namely the sale of goods or services, and also the sale of a right to claim goods or services in future. In order to answer this question, one needs to determine whether a sale under a loyalty programme has "separately identifiable components", as required by paragraph 13. Because the customer may or may not receive the loyalty awards when making the initial purchase, the awards are inherently separable from the initial goods or services - they are capable of being sold separately; they have an identifiable price; and they do not represent continuing involvement in the original goods or services. Sales under a loyalty programme may therefore be regarded as having two separate components, namely the goods delivered or services rendered at the time of the purchase, and the award credits (in other words, the right to claim goods or services in the future).

This method implies that award credits granted to customers as part of customer loyalty programmes are accounted for as separate components 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.

Measuring the deferred income

Once it has been determined that the multiple element approach is the appropriate way to account for the programme, the next matter to be considered is how to determine the amount of revenue for each of the two separate components.

Paragraph 9 of IAS 18 (AC 111) determines the following:

Revenue shall be measured at the fair value of the consideration received or receivable.

On the initial sales transaction, a customer would normally settle the transaction in cash. The consideration received is therefore cash, and the fair value thereof is the actual cash amount. When customer loyalty rights granted are accounted for under paragraph 13 of IAS 18 (AC 111), the cash amount (or the fair value of any other consideration) should be apportioned between the current sale and the award credits. The consideration allocated to the award credits represents the amount that the entity has received for accepting an obligation to supply awards if the customer chooses to redeem the credits. The estimate of this amount should reflect both the value of the awards and the entity's expectation regarding the proportion of the credits that will be redeemed.

IAS 18 (AC 111) does not prescribe an allocation method for multiple-element sale transactions. One acceptable allocation method may be to divide the total fair value of the consideration received between the initial sale and the award credits, based on relative fair values. In such a case, an entity should estimate the fair value of the award credits, which may be based on the discount that the customer would obtain when redeeming the award credits for goods or services. This discount should, however, be adjusted to take into account factors such as discounts to customers that have not earned award credits, forfeiture rates and the time value of money.

An entity may revise its expectations about the proportion of award credits that will be redeemed. Such a change in expectations does not affect the consideration that the entity has received for supplying the awards; in other words, the consideration was fixed at the time of the initial sale. A change in expectations may, however, affect the costs the entity will need to incur to supply the awards. If the unavoidable costs of supplying the awards will exceed the consideration received (in other words, allocated to the award credits on the initial sale) and receivable, the entity has an onerous contract. In such a case, the requirements of IAS 37 (AC 130), *Provisions, Contingent Liabilities and Contingent Assets* will apply.

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The timing of the recognition of revenue

The "multiple elements approach" requires an entity to divide the initial sales transaction into two components, namely the initial sale of the goods and services on the one hand, and the subsequent sale of goods or services on the other hand. Revenue for each of these separate components is recognised when the requirements of paragraph 14 of IAS 18 (AC 111) (for goods) or paragraph 20 (for services) are met. For services, the revenue for the two components is not normally recognised at the same time, as the stage of completion for the two components differs; in other words, the revenue attributed to the award credits would be deferred and recognised as revenue only once the entity has fulfilled its obligations in respect of the award credits by delivering the goods or services. Similarly with goods, the timing of the recognition of revenue for the initial sale may be different to that of the subsequent supply of goods (the awards), depending on when the risks and rewards of ownership associated with the goods are transferred to the customer. When the revenue relating to the award credits is recognised, any further costs to be incurred in respect of the loyalty rewards are also recognised.

The provision for future cost approach

The accounting in terms of this method is based on an analysis of paragraph 19 of IAS 18 (AC 111):

Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as matching of revenue and expenses. Expenses, including warranties and other costs to be incurred after the shipment of goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied. However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

When one reads paragraph 19, it seems that, when the expenses relating to a transaction for which revenue is to be recognised can be evaluated reliably, all the revenue pertaining to the transaction must be recognised at the time of sale, and any accompanying commitments must be recognised as a liability. This approach clearly differs from that based on paragraph 13 (the multiple elements approach), which rules for the postponement of some of the revenue.

Many commentators believe that the provision for future cost approach is applicable when the loyalty programme is a promotional programme and is therefore incidental to or a by-product of the original sales transaction. In the airline industry, for example, one of the key indicators to determine whether the nature of a frequent flyer programme is incidental is the non-displacement of revenue-paying passengers. The fact that there are loads that are not full has been cited in support of the assertion that the users of tickets obtained through the loyalty programme travel in seats on flights which would otherwise have been empty.

The conceptual difficulty with applying paragraph 19 to loyalty programmes is that it could be argued that paragraph 19 applies only if there are costs, such as installation or warranty costs, that need to be incurred in respect of goods or services that have already been delivered. Awards supplied to customers that redeem credits are not costs incurred in respect of the initial goods or services delivered: they are separate goods or services delivered at a later date.

The way forward

In November 2005, the IFRIC started with a project on accounting for loyalty programmes. During September 2006, the IFRIC published IFRIC Draft Interpretation D20, *Customer Loyalty Programmes*, for public comment (the comment period expired on 6 November 2006). The Draft Intepretation was also published locally by SAICA as ED 218.

In this Draft Interpretation, the IFRIC rejects the use of the provision for future cost approach for all loyalty programmes, as the IFRIC considers the multiple elements approach to be the most appropriate application of IAS 18 (AC 111).

Other issues – intangible assets

One might consider whether it is appropriate to capitalise the costs incurred on loyalty programmes as intangible assets in terms of IAS 38 (AC 129), *Intangible Assets*. It might be argued that it does not seem sound that a loyalty programme should lead to expenses in the financial records when the scheme is globally beneficial to the company. It should, however, be noted that the benefits from such a programme arise from building a customer relationship between the company and consumers. Such benefits would fall into the class of items described in paragraph 16 of IAS 38 (AC 129) and would accordingly not be recognised as an asset unless they are supported by legal rights or when they result from an exchange transaction.

Concluding remarks

Although the multiple elements approach is logical and conceptually sound, one might argue that it is more complicated than recognising the full revenue and an associated liability for the expected cost of supplying the awards, in other words, applying paragraph 19 of IAS 18 (AC 111). It should, however, be considered that, as with all other issues in International Financial Reporting Standard or SA GAAP, the proposed Interpretation would not apply to immaterial items and that the systems and processes required to apply the proposed method (paragraph 13) could be similar to those needed for the alternative of applying paragraph 19.

Entities that operate loyalty programmes should consider the implications of the Draft Interpretation carefully, because, once it has been finalised, it is expected that the Interpretation will be effective soon after its release, and will need to be applied fully retrospectively. Entities that have therefore applied the provision for future cost approach in the past will need to restate comparative amounts.

Elmar Venter MCom (Taxation) CA(SA) is a Senior Lecturer in the Department of Accounting at the University of Pretoria.

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