EFRAG

European Financial Reporting Advisory Group

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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DRAFT ENDORSEMENT ADVICE

Comments should be sent to Commentletter@efrag.org by 7 October 2007

Dear Mr Holmquist

Adoption of IFRIC Interpretation 13 Customer Loyalty Programmes

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRIC Interpretation 13 *Customer Loyalty Programmes*—henceforth 'IFRIC 13' or 'the Interpretation'. IFRIC 13 was issued in an exposure draft which EFRAG commented on.

IFRIC 13 provides guidance on how entities should account for customer loyalty programmes under the existing requirements of IAS 18 *Revenue.* In particular, the Interpretation states that entities shall account for such award credits as a separately identifiable component of the sales transaction in which they are granted. The revenue relating to the award credit component of the transaction thus identified should therefore be deferred initially and recognised as revenue when the award credits are redeemed and the entity fulfils its obligations to supply awards. IFRIC 13 will apply for annual periods beginning on or after 1 July 2008, with earlier application being permitted.

EFRAG has carried out an evaluation of IFRIC 13. [As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.]

EFRAG supports IFRIC 13 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRIC 13 and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix 1 - Basis for Conclusions'.

A minority of EFRAG members has concerns about IFRIC 13 that cause those members to believe that EFRAG should not recommend IFRIC 13 for endorsement. The reasoning of those members is explained in the attached 'Appendix 2—Dissenting Views'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
Basis for Conclusions

This appendix sets out the basis for the conclusions reached and for the recommendation made by EFRAG on IFRIC 13 Customer Loyalty Programmes*.*

1 When evaluating IFRIC 13 *Customer Loyalty Programmes* EFRAG considered the following key questions:

(a) Is there an issue which needs to be addressed?

(b) If there is an issue which needs to be addressed, is an Interpretation an appropriate way of addressing it?

(c) Is IFRIC 13 a correct interpretation of existing IFRS?

(d) Does the accounting treatment that results from the application of IFRIC 13 meet the criteria for endorsement by the EU?

2 [Having formed tentative views on the issues and prepared a draft endorsement advice letter, EFRAG issued that draft letter for comment on 7 September 2007 and asked for comments on it by 7 October 2007. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.]

IS THERE AN ISSUE WHICH NEEDS TO BE ADDRESSED?

3 There are many different types of customer loyalty programme. EFRAG understands that currently even very similar types of programme are being accounted for differently, and that the amounts involved are often very significant. EFRAG agrees that this diversity in the way entities account for such programmes is undesirable and is an issue that needs to be addressed.

IS AN INTERPRETATION AN APPROPRIATE WAY OF ADDRESSING THIS ISSUE?

4 This diversity in practice in accounting for customer loyalty programmes arises out of uncertainty—and as a consequence differences of view—as to how IAS 18 *Revenue* should be applied to customer loyalty programmes. Where an inconsistency in accounting practice is caused by differing interpretations of one or more existing standards it will generally be appropriate to deal with the issue by means of an Interpretation.

5 Some EFRAG members noted that the IASB and FASB are jointly carrying out a comprehensive review of accounting for revenue and that a Discussion Paper on the subject is due in 2008. They wondered whether it was as a result premature for IFRIC to be developing some new thinking on a revenue issue, particularly as the Interpretation might require changes in accounting that the longer-term joint project might reverse: a situation that would place unnecessary burdens on preparers and users.

6 On the other hand, those EFRAG members noted that the IASB's active agenda currently covers many aspects of accounting and that, if IFRIC is debarred from issuing Interpretations on all those aspects of accounting, its scope will be severely restricted. They also noted that it would be several years before the joint IASB/FASB project would result in a standard and, if IFRIC could not act in

the meantime, that meant several years of diversity in accounting practice and a lack of comparability.

7 Having taken the above considerations into account, EFRAG concluded that it was appropriate to issue an Interpretation to resolve the issue of accounting for customer loyalty programmes.

IS IFRIC 13 A CORRECT INTERPRETATION OF EXISTING IFRS?

Scope

8 Customer loyalty programmes can take many different forms, and IFRIC 13 applies only to customer loyalty award credits granted by the reporting entity to their customers as part of a sales transaction and which (subject to meeting any further qualifying conditions) the customers can redeem in future for free or discounted goods or services. Thus, awards or gifts that cannot be identified as part of a sales transaction (such as welcome gifts given by a bank to new customers opening an account or periodic or discretionary awards of air miles and similar) are not within IFRIC 13's scope, and neither are awards redeemable in cash.

9 IFRIC explains that it has scoped IFRIC 13 in this way because the transactions within scope are the transactions mainly responsible for the diversity of practice. EFRAG agrees and supports the scope as defined.

Issue 1—Two sales or just one?

10 IFRIC 13 deals with two broad issues. The first issue is which paragraph of IAS 18 should be applied when an entity grants award credits as part of a sales transaction.

(a) One possibility is that paragraph 13 of IAS 18 should be applied. That would mean that the transaction would be treated as involving two separately identifiable components (ie it is a multiple-element arrangement): the sale of the goods or services involved and the sale, for delivery at some point in the future, of rights in respect of a second transaction. (For example, in the case of air miles, the transaction would involve the sale of an aeroplane ticket plus the sale of award credits.) As the second sale has not yet been delivered, any consideration received that relates to that component is not recognised immediately but is instead deferred.

(b) The other possibility is that paragraph 19 of IAS 18 should be applied. That would mean that the transaction would be deemed to have only one component and the estimated cost of fulfilling the obligation arising from the award credit is part of the cost of sales for that one component.

(c) The third possibility is that paragraph 13 should be applied to some transactions falling within the scope of IFRIC 13 and paragraph 19 to some others.

11 In IFRIC's view, paragraph 13 applies if a single transaction consists of two or more separate goods or services that are to be delivered at different times. The issue for IFRIC was, therefore, whether the award credits represent an element of the transaction and whether there are two separate deliveries, one of which occurs at a point later than the initial transaction.

(a) IFRIC concluded that award credits granted to a customer as a result of a sales transaction *are* an element of the transaction itself. They represent rights granted to the customer. They are granted to the customer as part of the sales transaction, and can be contrasted with market expenses which are incurred independently of the sales transaction.

(b) The IFRIC also concluded that loyalty awards are *not* delivered to the customer at the same time as the other goods or services. Instead they are delivered when they are used. Put another way, award credits are rights to a future delivery of goods or services, which by definition the entity has not yet delivered.

As a result, the consensus is that paragraph 13 should be applied.

12 EFRAG members discussed a number of issues arising from this consensus and rationale. The main issue was whether award credits granted to a customer as a result of a sales transaction are an element of the transaction itself.

(a) Some EFRAG members argued that in many cases the awards are in effect forced on the customer, in that the customer is seeking to acquire the accompanying goods or services (the primary object of the transaction) and acquires the award credits only because the primary object is not sold separately. However, most EFRAG members noted that a 'forced' sale is still a sale.

(b) Some EFRAG members argued that in any event the granting of the award credits was incidental to the transaction. Many customers do not bother to redeem their award credits. Furthermore, in many cases the grantor is able to alter the value of the award credits subsequent to the grant, and customers will not pay for something whose value is outside their control. In effect, the decision to purchase the item that is the primary object of the transaction is taken independently of the award scheme and therefore as far as the customer is concerned they are entering into only one transaction at an agreed price. However, most EFRAG members noted that, although the granting of the award credits might sometimes be a largely incidental part of the transaction, in other cases that would not be the case. The widespread use of such programmes by entities demonstrates that they are believed to hold value in the eyes of the customer. The fact that the value of the award credits during the post-grant period may not always or fully be under the customer's control does not mean they were incidental to the transaction.

13 EFRAG discussed whether the cost of fulfilling the obligations arising from the grant of award credits might possibly be a marketing expense (as argued in IFRIC 13 BC6) rather than a cost of the sale of the second component of the transaction. EFRAG members noted that in BC7 of the Interpretation the IFRIC states that marketing costs are incurred independently of the sales transactions they are designed to generate, and the cost of fulfilling the obligations arising from the grant of award credits are not independent of the transaction. Most EFRAG members accepted this argument. However, the failure of some customers to redeem award credits was seen by one member as an indication that there is not a direct link between a sale and redemption of an award. In that member's view, the purpose of granting the award credits is to enhance the marketability of the primary object of the transaction, so the cost of fulfilling the obligations is in substance a marketing cost.

14 Having considered the above arguments, the majority of EFRAG members concluded that this aspect of the consensus is a reasonable interpretation of IAS 18.

Issue 2—How should paragraph 13 of IAS 18 be applied to customer loyalty programmes?

15 Having concluded that all customer loyalty programmes falling within the scope of IFRIC 13 should be accounted for in accordance with paragraph 13 of IAS 18, IFRIC then considered how exactly that paragraph should be applied. In particular:

(a) how much consideration should be allocated to the award credit component;

(b) when should the revenue be recognised; and

(c) if a third-party supplies the awards, how revenue should be measured?

Allocation of the consideration

16 Paragraph 13 of IAS 18 in effect requires the total consideration arising on the transaction to be allocated between the two elements of the transaction. IAS 18 says very little about how that should be done.

(a) Paragraph 13 states that, “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.”

(b) Paragraph 9 explains that the general principle is that revenue shall be measured at the fair value of the consideration received or receivable.

Paragraph 13 of IFRIC 12 *Service Concession Arrangements* states that “consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered…”

17 IFRIC concluded in IFRIC 13 that the consideration allocated to the award credits “shall be measured by reference to their fair value, ie the amount for which the award credits could be sold separately.” EFRAG members considered a couple of issues relating to this requirement.

(a) IFRIC 12 requires the total consideration to be allocated between the two elements of the transaction by reference to their relative fair values, whilst IFRIC 13 requires the consideration allocated to one element (the sale of relating to the loyalty award) to be based on its fair value whilst the consideration allocated to the other element (the sale that is the primary object of the transaction) will simply be the residual. Thus, two Interpretations of the same standard require different principles to be applied in analogous situations.

(b) IFRIC 13 defines the fair value of the award credits as being the amount for which the award credits could be sold separately. That is an exit value. It is not clear from IFRIC 13 why the IFRIC chose to define fair value as an exit value when IAS 18.7 already defines fair value more broadly (“the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”). EFRAG members considered whether the effect could be to create uncertainty. One EFRAG member was also concerned that the IFRIC had chosen to define fair value whilst the IASB is still in the process of deciding what fair value should mean.

18 However, the majority of EFRAG members were not too concerned about these issues. Whilst they agreed in the case of (a) that it was undesirable for two Interpretations of the same standard to require the application of different principles, they thought in practice the principles were unlikely to cause significant comparability issues. And, whilst they agreed that it was unfortunate that IFRIC had chosen to introduce a new definition of 'fair value', particularly as IAS 18 already contains a definition, they noted that applying the exit value notion would result in compliance with both definitions, so again the issue would not have major practical consequences in this case. As a consequence, EFRAG accepted this part of the consensus.

When should the revenue allocated to the award credits be recognised?

19 IFRIC then considered when the revenue allocated to the award credits should be recognised in the income statement. IAS 18.13 requires that, when consideration is received in respect of a multiple-element arrangement but an element has not yet been delivered, the consideration (ie revenue) allocated to that element should be deferred and recognised when delivery takes place. IFRIC concluded that:

(a) if the entity (rather than a third party) supplies the award, delivery will take place when the award credits are redeemed or when the entity otherwise fulfils its obligations in respect of the award credits.

(b) if the awards are supplied by a third party, the entity needs to assess whether it is acting as a principal or as an agent in the arrangement. Revenue is measured by the entity as the gross consideration allocated to the award credits where it is acting as principal or as the net amount (the difference between the consideration allocated to the award credits and the amount payable to the third party) when it is acting as an agent. The entity recognises the revenue when it fulfils its obligations in respect of the awards or when the obligation to supply the awards has passed to the third-party.

20 EFRAG believes these conclusions are consistent with IAS 18 and therefore accepts this aspect of the consensus.

Summary—Issue 2

21 Thus, EFRAG agrees that, if all customer loyalty programmes falling within the scope of IFRIC 13 should be accounted for as multiple-element arrangements in accordance with paragraph 13 of IAS 18, then IFRIC 13's consensus on the issues described in paragraph 16 above is an acceptable interpretation of existing IFRS. EFRAG therefore supports it.

Conclusion

22 Having taken into account all the arguments discussed above, the view of the majority of EFRAG members is that IFRIC 13 is, on balance, an appropriate interpretation of existing IFRS.

DOES THE ACCOUNTING TREATMENT THAT RESULTS FROM THE APPLICATION OF IFRIC 13 MEET THE CRITERIA FOR ENDORSEMENT BY THE EU?

23 EFRAG has considered whether it believes that IFRIC 13 meets the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that the Interpretation:

(a) is not contrary to the ‘true and fair principle’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG has also considered whether it is in the European interest to adopt the interpretation.

24 EFRAG has previously concluded that the existing IAS 18 meets the EU endorsement criteria and has concluded in the discussion above that IFRIC 13 is an appropriate interpretation of IAS 18.

Relevance

25 EFRAG has considered whether the information that results from the application of IFRIC 13 is relevant, and has concluded that it is. The effect of IFRIC 13 is to defer the recognition of the revenue related to customer loyalty awards credits until the entity has fulfilled its obligations in respect of these. As the operation of customer loyalty schemes can be an important part of the business model of the entities that use them, EFRAG believes that the deferral of such revenue until the obligation has been fulfilled results in relevant information being provided.

Reliability

26 EFRAG has also considered the reliability of the information that will be provided. In EFRAG’s view, the main issue here is whether the requirement that fair value be used as a reference to measure the consideration allocated to the award credits would lead to difficulties in estimation and, as a consequence, unreliable information being presented in the financial statements. In this context it was noted that award credits will rarely, if ever, be sold in an observable, deep and active market. In addition, the guidance provided in the Interpretation on how the award credits should be measured is limited. While it may be comparatively simple to arrive at a fair value where the award credit has a contractual value (such as where points with a monetary value or discounts at a specified percentage rate are given), in other instances it may be more difficult to estimate a fair value as there is no real market to base estimates on (such as in the case of air miles). Entities will therefore be obliged to estimate an amount based on their experience and judgement of customer values and behaviours. Indeed, some EFRAG members questioned whether the resulting range of estimated amounts might be so broad and varied that meaningful comparison between entities will be difficult, even for entities in the same industry.

27 However, EFRAG noted that there are a number of instances under current IFRSs where estimates involving a great deal of judgement are used. Examples include the “expected outcome” approach to estimating provisions under IAS 37, loan loss provisioning, the estimation of the fair value of employee share options

under IFRS 2, and the assumptions used for valuing pension arrangements under IAS 19. EFRAG believes that the reliability issues that arise when estimating the fair value of award credits under IFRIC 13 are of a similar level to those that arise under other standards. It also believes that they are not dissimilar to the issues that would arise were entities required to make a provision for unredeemed award credits. As a result, the majority of EFRAG members concluded that IFRIC 13 will satisfy the reliability criterion.

28 One EFRAG member however believes that reliability remains a concern. In that member's view, in most cases in which a high degree of judgement and subjectivity is involved in arriving at an accounting estimate, that degree of judgement and subjectivity has to be accepted because the next best basis, method or policy is unacceptable; however, that is not the position in this case. The next best policy would have been to treat the award credits as a marketing expense; a policy that is both 'good enough' and would require much less judgement and subjectivity. The majority of EFRAG members do not agree with this analysis. In their view treating the award credits as a marketing expense would result in profits being recognised prematurely, in liabilities being understated, and in a similar amount of judgement being needed to determine the provision to be made.

Comparability

29 The IFRIC's objective in issuing IFRIC 13 was to eliminate the cause of the current diversity in practice in the accounting treatment of customer loyalty programmes and thereby improve the comparability of the information provided in financial statements. EFRAG believes that has been done. EFRAG accepts that, in addressing the current uncertainty as to how existing IFRS should be applied, IFRIC 13 requires measures to be used that involve a degree of judgement being applied, and that some EFRAG members have questioned whether (as explained above) that degree of judgement might raise subjectivity and therefore comparability issues of its own. The majority of EFRAG members concluded however for the reasons set out in the previous paragraph that the comparability criterion was still met.

Understandability

30 One EFRAG member had concerns about the understandability of the information that results from the application of IFRIC 13. That member was concerned that the degree of judgment involved would, for the reasons explained in paragraph 29 above, introduce unacceptable—and unnecessary—arbitrariness into the performance information. However, other EFRAG members disagree with this analysis for the reasons also set out in paragraph 30. In their view, by requiring a single method of accounting for the customer loyalty programmes within its scope, IFRIC 13 will in fact enhance the understandability of financial statements.

True and fair

31 One EFRAG member agrees with the argument set out in BC6 of IFRIC 13, and thus believes that the correct interpretation of IAS 18 is that award credits are marketing costs. As a result, that member believes the consensus contains a fundamental flaw in that it does not enable the revenue to be recognised when it has been earned. For that reason this member believes that the "true and fair" principle is not satisfied. However, other EFRAG members believe that the consensus is either the correct interpretation of IAS 18 or at the very least an acceptable interpretation of IAS 18, and do not believe it contains a fundamental

flaw. In their view there is no inconsistency between the requirements of IFRIC 13 and the true and fair requirement.

European interest

32 EFRAG members considered whether adoption of the Interpretation might cause those entities that are using a different approach currently to incur costs in excess of the benefits expected from applying the accounting IFRIC 13 requires. However, they noted that, although implementation of IFRIC 13 would involve some initial costs, entities currently applying different approaches are already using some of the assumptions which are required by the Interpretation. They also noted that the Interpretation makes it clear that it is acceptable to account for the initial deferral and the subsequent recognition of revenue on the basis of a grouping or portfolio of transactions. EFRAG members believe, therefore, that these factors will in most cases mitigate the cost of compliance.

33 EFRAG also notes that IFRIC 13 will eliminate the diversity of accounting currently adopting in respect of customer loyalty programmes, and will therefore enhance the comparability of the information provided. It will also ensure that the already endorsed IAS 18 is applied appropriately.

Conclusion

34 After considering all the above arguments, the majority of EFRAG members has concluded that on balance IFRIC 13 satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

Appendix 2
Dissenting Views

The views of the EFRAG members who voted against recommending endorsement of IFRIC 13 are explained in this appendix.

A minority of EFRAG members believe that IFRIC 13 should not be endorsed for use in the European Union and therefore dissent from EFRAG's decision to recommend its endorsement. The reasons that that minority has reached this conclusion are as follows:

(a) One member believes that the correct treatment of award credits is to account for them as marketing costs under paragraph 19 of IAS 18. The reasons for this are discussed in Appendix 1, paragraphs 12 and 13 of Appendix 1, As a result, that member believes (as explained in paragraph 31) that IFRIC 13 does not satisfy the true and fair principle.

(b) One member believes that the endorsement criteria of reliability, comparability and understandability are not met by the accounting required by IFRIC 13, for the reasons set out in paragraphs 28 to 30 of Appendix 1.