Rechnungslegungs Interpretations
Accounting Interpretations Committee

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Mr Robert Garnett
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International Financial Reporting Interpretations Committee
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Berlin, 10 November 2006

Dear Bob

Comment Letter on IFRIC Interpretation D20 *Customer Loyalty Programmes*

We appreciate the opportunity to comment on the draft Interpretation IFRIC D20. We fully endorse the IFRIC´s aim to support the IASB in establishing and improving International Financial Reporting Standards.

We generally agree with the first sentence of paragraph 5 of the Consensus that states that an entity shall apply paragraph 13 of IAS 18 and account for award credits as a separately identifiable component of the sale transaction(s) in which they are granted. However, we are not entirely sure whether all award credits granted that are within the scope of IFRIC D20 can be considered as independent components of the sale transaction(s). As set out in paragraph BC6 some award credits could be viewed as serving marketing purposes only (that would imply the recognition of an expense at the time of the initial sale), especially when these awards are insignificant in value. Nevertheless, we are not supportive of this "third view" described in paragraph BC6 because grounding the dividing line between a separately identifiable component of a transaction and marketing expense on the value or nature of award credits seems to be ambiguous and lacks a principle-based foundation. However, a more in-depth analysis of the various types of customer loyalty programmes used in practice might reveal a more suitable dividing line that neither the IFRIC nor the AIC is currently aware of. The consequence would be a scope limitation that might be appropriate in light of the great variety of customer loyalty programmes and their heterogeneous features. This variety might also imply the need for different accounting treatments.

Though we agree with the application of paragraph 13 of IAS 18 for award credits we do not support the measurement principle set out in paragraph 5 and 6 of IFRIC D20, i.e. to allocate the fair value of the consideration received or receivable by reference to the relative fair values of the components (i.e. the goods and services sold and the award credits granted). While the relative fair value approach is established in US GAAP (see EITF 00-21) this is not the case in the IFRS environment. It is unclear why the IFRIC introduces a new or at least uncommon measurement principle into IFRS, although these are currently based on an absolute fair value approach (see for example IFRS 3.56). If the IFRIC sticks to the use of this principle we consider it as necessary that the rationale is better explained in the Basis for Conclusions (including an explanation why other measurement methods for multiple element arrangements currently applicable under IAS 18 are ruled out). The IFRIC should also avoid that the requirement of the relative fair value approach might have practical implications that go beyond transactions covered by the scope of IFRIC D20.

While the members of the AIC unanimously object to the relative fair value approach they are divided on the preferred measurement approach for award credits. Some members argue for an incremental cost approach, i.e. the measurement of the award credits granted with reference to the costs that will arise when these award credits are redeemed by customers in the future. This amount would be deducted from the consideration received or receivable (i.e. from revenue) and deferred as a liability until the award credits are redeemed. The members of the AIC in favour of the incremental cost approach emphasise that this cost approach better reflects the economic substance of customer loyalty programmes than fair value approaches: The entity granting the award credits is in arrears with a non-cash benefit (i.e. a contribution in kind); the substance of customer loyalty programmes implies that at the time, when the award credits are redeemed, only the costs for settling the obligation to provide the customers with the contribution in kind should be taken into account. A similar rationale can be found in IAS 18.10 for volume rebates which are in substance comparable to award credits. In addition, the incremental cost approach would avoid the many assumptions that are inevitably necessary when the fair value of award credits is to be determined (see paragraph 7 of IFRIC D20).

Other members of the AIC hold the view that from a conceptual point of view the application of the absolute fair value approach (i.e. the measurement of both components at their respective fair values) would be most appropriate. This would imply that the sum of the fair values and the consideration received or receivable might be different (with the consequence of having to recognise this difference as profit or loss at the time of the initial sale). The IFRIC, however, seems to have the intention to avoid this outcome (what should be explained in the Basis for Conclusions) because it does not refer to the value of the components of the initial sale, but to the allocation of the consideration received or receivable (see paragraphs 5 and 6 of IFRIC D20). Taking this into account, those members of the AIC conceptually in favour of a fair value approach argue that the allocation using a residual approach would lead to more appropriate results than the reference to the relative fair value approach proposed by the IFRIC.

According to the residual approach the consideration received is first allocated to one component (preferably to the goods or services sold because these will very likely be much more material than the award credits) and then the residual is allocated to the other component. This would avoid the deficiency of the relative fair value approach that results – while using the correct proportion of fair values – in a distortion of the fair value measurement of both components if the sum of the fair values does not equal the consideration received. In this situation, measuring the significant component (usually the goods or services received) at its absolute fair value instead of referring to the relative fair value seems also more convincing because through this a disparity between the costs of the goods or services (recognised in full) and the related revenue (recognised relatively to the fair value of the award credits) is avoided. Still another advantage of the residual approach is that problems possibly arising in practice to reliably measure the fair value of award credits (for example due to the lack of an active market for certain type of award credits) have no relevance because the award credits are not measured at their fair value but at the residual.

Another issue of concern – not related to measurement – is the statement in paragraph 11 that refers to IAS 38. Since we are not aware of situations in which customer loyalty programmes may create or enhance customer relationship intangible assets and since paragraph 11 seems to be only loosely related to the issue of the draft Interpretation we suggest to the IFRIC deleting this paragraph or explaining the rationale behind it more comprehensively in the Basis for Conclusions.

Finally, we have reservations against full retrospective application of IFRIC D20 if the IFRIC confirms the relative fair value approach. The AIC understands that the retrospective determination of the fair values of the award credits might often be difficult, especially when award credits are non-forfeitable and were granted many years in the past. Furthermore, hindsight bias would be unavoidable.

If you would like further clarification of the issues set out in this comment letter, please do not hesitate to contact me.

With best regards

Stefan Schreiber
AIC, Chairman