EFRAG

European Financial Reporting Advisory Group

XX September 2006

D20 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by October 27, 2006

Dear Sir/Madam,

Re: IFRIC Draft Interpretation D20 Customer Loyalty Programmes

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IFRIC Draft Interpretation D20 *Customer Loyalty Programmes ('D20')*. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

D20 addresses accounting by entities that operate or otherwise participate in customer loyalty programmes for their customers in which the entities grant their customers award credits, such as 'air miles' and 'points', that subject to meeting further qualifying conditions, the customers can redeem for free or discounted goods and services. It addresses how entities should recognise and measure their obligations to provide the free or discounted goods and services if and when customers redeem the award credits. Specifically it clarifies whether entities should follow either paragraph 13 or paragraph 19 of IAS 18 (Revenue) when accounting for the award credits offered to their customers.

We welcome the initiative and support the IFRIC's efforts to provide guidance that establishes a common and consistent approach to customer loyalty programmes for all IFRS users. We agree that IFRSs lack specific guidance on how entities should account for credits that it awards to their customers under loyalty programmes, and as a consequence practices have diverged. Accordingly, we agree that an interpretation is helpful for such transactions, however we do not agree with the consensus proposed by the IFRIC, because we are not convinced that credits awarded by an entity under a customer loyalty programme are separately identifiable components of revenue (and in particular of the sales transaction(s) in which they are granted).

Also even if award credits were separately identifiable components of the revenue transaction (in which they were granted) we have particular concerns regarding reliability-of-measurement issues in measuring award credits granted under loyalty programmes.

As a conclusion, we support the view that the entity's obligation to provide free or discounted goods and services under customer loyalty programmes be recognised as an expense at the time of the initial sale and measured in accordance with IAS 37 (i.e. cost/provision approach - applying paragraph 19 of IAS 18 as described in the Basis For Conclusions paragraph BC4). We generally agree with the arguments noted in BC4 in support of the cost/provision approach.

Our detailed comments on this draft Interpretation are set out in the Appendix to this letter. In the Appendix we have also noted some remarks to the wording used in D20 and areas which we believe require clarification.

If you would like further clarification of the points raised in this letter, Isabel Batista or I would be happy to discuss these further with you.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman

Appendix - EFRAG's detailed comments on IFRIC D20

The issue addressed in D20

1 When award credits are granted by an entity to their customers in customer loyalty programmes, the entity enters into an obligation. The issues addressed in D20 are whether such award credits should be accounted for:

1) By recognising all revenue on the initial sale immediately and recognising a provision for any costs of fulfilling the obligation under the award credits (referred to as the cost/provision approach); or

2) As a separately identifiable component of revenue and, if so, how this component should be measured and when this revenue should be recognised (referred to as the deferred revenue approach).

2 Both approaches described above in views 1) and 2) above are currently interpreted as being permitted under IAS 18 (by applying either paragraph 13 or paragraph 19 of IAS 18 - are explained in paragraphs BC4 and BC5 respectively). However IAS 18 provides no guidance on when components are separately identifiable or when it is necessary to apply the recognition criteria to separately identifiable components.

3 Both approaches result in a liability being recognised, however a fundamental difference lies in the measurement of the liability. A further difference lies with the timing of revenue recognition in particular the recognition of the profit margin on the sale transaction. D20 is seeking to eliminate divergence in practice arising from applying either paragraph 13 or 19 of IAS 18 in accounting for customer loyalty programmes.

Consensus -Is a loyalty programme conceptually a multiple sale arrangement?

4 Our main concern regarding the consensus reached by IFRIC in D20 is that we are not convinced that credits awarded by an entity to customers under a customer loyalty programme are a separately identifiable component of revenue and in particular of the sales transaction(s) in which they are granted. For instance:

- We believe that the IFRIC has reached a conclusion based primarily on the *assumption* that award credits are separately identifiable components of revenue (paragraph 5 and supported by BC5 and BC7). We view this assumption as an interpretation of the general requirements of IAS 18 that are still open for debate and as a consequence believe that D20 lacks a clear principle to support the conclusion reached. The question of what is meant by a ´separately identifiable component´ is a difficult one and therefore we believe that it is incorrect to make this assumption prior to having an appropriate debate on multiple sale arrangements.

- Customer loyalty programmes operate in various different ways and are sometimes incidental to the activities of the entity. For example the cost to an airliner of granting a "free ticket" to a customer when awards are redeemed by the customer can be considered "incidental" as long as the seats awarded represent seats that are unlikely to be sold, or are limited in number so that it is unlikely that the airliner will be giving away seats which it could instead sell to a fare-paying customer. We question whether it would be correct to view the ‘incidental piece’ of the transaction as a separate revenue component and believe instead that it is conceptually correct to provide for the incidental cost (i.e. obligation) that resulted directly from the initial sale.

Consensus - Allocation/measurement of proceeds

5 As outlined in our letter we are concerned with reliability-of-measurement issues when determining the fair value of award credits. D20 paragraph 6 proposes that the proceeds from the customer shall be allocated between the item sold and the award credit granted by reference to their *relative fair values*, i.e. the amounts for which the item sold and the credit award could be sold separately. However there are several factors specific to award credits which could impair the reliability of determining fair value. For instance, award credits are often unique products that generally cannot be categorised within the context of a “relatively homogeneous population”. The significant diversity of awards granted may result in lack of “products to reference to” and therefore require a significant degree of estimation when determining fair value. As a consequence the uncertainties underlying the valuation aspects may in fact undermine one of the objectives the IFRIC is trying to achieve, namely consistently in the measurement of obligations arising from customer loyalty programmes.

Consensus –measurement of forfeitures /recognition

6 We believe that the guidance provided on forfeitures has been addressed in a simplistic and also an unclear manner. IAS 18 does not address forfeiture. In paragraph 8, D20 proposes that revenue is recognised based on the number of awards that have been redeemed relative to the total number expected to be redeemed. As explained in BC11 and B12, this seems to imply that expected forfeiture is taken into account when estimating fair value of the award credit by considering the proportion of awards that are expected to be redeemed i.e. the sales value is an historical value and hence cannot be subsequently changed. This is explicitly stated in BC 12 which emphasis that the consideration (and hence the revenue) was fixed at the time of the initial sale.

7 As a consequence revisions to the ‘initially expected forfeiture rates’ are accounted for according to paragraph 10 of D20 (and explained in BC 12) which proposes that if at any time the unavoidable costs of meeting the obligation to supply the awards are expected to exceed the consideration received or receivable for them, an entity should follow the guidance in respect to onerous contracts in accordance with IAS 37. However we believe that paragrapghs 8 and 10 are not clear and are not property explained in BC11 and BC 12. To clarify this, we would suggest that the IFRIC include an example(s) to illustrative what paragraphs BC 11 and BC 12 are actually trying to say.

8 As stated above, D20 provides guidance in respect to situations which may lead to an onerous element in respect to an obligation to redeem an award granted, for instance a change in expectations about the number of awards that will be redeemed. D20 does not however, mention how deferred revenue (i.e. the remaining balance) should be recognised if (for instance due to a change in the expected ´forfeiture´) the costs to meet the obligation are less than the consideration received or receivable for them (i.e. how to account for the potential ‘gain’). We would recommend the IFRIC to address this in D20.

Consensus – Attributing revenue to awards

9 D20 paragraph 7 allows the fair value of the award credits to be estimated by reference to the discount that the customer would obtain in redeeming the award credits. In this

paragraph the IFRIC refers to the “nominal value of the discount”. It suggests that this nominal value be adjusted for certain factors (if needed). We do not clearly understand what is actually meant by ´nominal´ value of the discount in the context of paragraph 7 and therefore suggest that the IFRIC clarifies this point.

Our conclusions on a preferred method

10 As noted in our letter, we support the view that the entity’s obligation to provide free or discounted goods and services under customer loyalty programmes be recognised as an expense at the time of the initial sale and measured in accordance with IAS 37 (i.e. cost/provision approach - applying paragraph 19 of IAS 18 as described in BC4). As explained earlier, we are not convinced that credits awarded by an entity to customers under a customer loyalty programme are separately identifiable components of revenue. We agree with the arguments noted in BC4 in support of the cost/provision approach. Further, we believe that this approach is consistent with that generally applied to similar transactions that are outside the scope of D20. Additionaly, we generally believe that this approach is easier to apply and produces at least equally relevant and reliable information compared to the deferred revenue approach proposed in D20.

11 We questioned whether, if the IFRIC in finalising the draft Interpretation proposes the view in BC4, it would be necessary for the IFRIC to provide guidance on how the obligation arising from award credits under customer loyalty programmes should be measured. However, we believe that no guidance is needed and that the obligation should be measured in a way similar to the way other obligations are measured and as a consequence the guidance in IAS 37 should be followed (i.e. the best estimate of the expenditure required to settle the obligation at the balance sheet date).

Question for EFRAG's constituents
We would welcome comments from respondents on our views noted in paragraphs 10 and 11 above.

Sales of awards to third parties

12 Sales of awards credits by an entity to another entity are not specifically addressed in D20. We believe that such transactions are common practice amongst loyalty programme operators (for example an airliner selling ‘air miles’ to a credit card company). We have asked ourselves whether the accounting for such sales should be different to that of accounting for customer loyalty programmes. We believe that the intention of IFRIC could be that such transactions are accounted for in a way similar to teh consensus reached in D20. For instance if an entity sells credits (i.e. air-mile points) to a third party one can question whether the entity should (a) recognise revenue when the credits are sold and recognise a provision according to the same principles as described in BC4, or (b) defer the revenue and follow the principles based on the consensus reached in D20. We believe that the IFRIC intends that the consensus in D20 is followed (based on for example BC 7a).

13 Some EFRAG members support the view that sales of awards to third parties should be accounted for according to the same principles as outlined in BC4. However, overall we generally agree that the issue on “sales of awards to third parties” cannot be appropriately addressed without a proper debate on “what is revenue and how is it defined”. As a consequence we believe that sales of awards credits by entities to third

parties should be accounted for under the general revenue recognition criteria of IAS 18 and that no specific reference is required in D20 to these types of transactions.

Question for EFRAG's constituents
We would welcome your views on accounting for the sale of award credits to third parties.

Cost benefit analysis

14 It is worth noting that the IASB and the FASB have a Revenue project that will presumably address most of the issues addressed in D20. However given the timeline for the Revenue project, IFRIC decided to try and resolve the issues through an Interpretation. As stated in our letter, although we welcome the initiative to achieve a common approach on accounting for loyalty programmes we might not support such an initiative at all costs and are concerned that the costs involved to reach such a common approach may outweigh the benefits.

Question for EFRAG's constituents
We would welcome all comments on the cost benefit analysis.

Effective date and transitional requirements

15 EFRAG supports the general principle that all new Interpretations and new or revised IFRSs should be applied retrospectively. For that reason, we support the proposal in D20 for full retrospective application.