EFRAG

European Financial Reporting Advisory Group

24 November 2006

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

Dear Sir/Madam

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 Interpretation on the issue.

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. It proposes that an entity should apply paragraph 13 of IAS 18 *Revenue* and account for award credits as a separately identifiable component of the initial sale transaction and in doing so should allocate a part of the overall consideration to the award credits granted by reference to their fair value.

We support the IFRIC's efforts to provide interpretative guidance to establish a consistent approach on accounting by entities for customer loyalty programmes. As there seems to be some divergence in practice we agree that an interpretation is helpful for transactions under such schemes.

However, we have several reservations regarding the proposals in D20 and, as a consequence we do not support the consensus proposed by the Draft Interpretation. In particular, we do not support the adoption of a deferred revenue approach. Instead, we favour adoption in D20 of the so-called cost/provision approach and, believe that this approach will, in most instances, result in the most appropriate accounting treatment. We believe that the lack of a clear set of guidelines on segmentation of revenue transactions will lead to inconsistent accounting practices and, generally we doubt whether a consistent and comparable approach will be achieved if the measurement model being proposed is adopted. For those reasons, and until further research is undertaken, we believe that the cost/provision approach will provide the most suitable level of comparability of information in the financial statements.

Our detailed comments on this draft Interpretation are set out in the Appendix to this letter.

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. D20 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, and whether such award credits should be accounted for:

   (a) 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

   (b) 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 (a) and (b) are currently interpreted as being permitted under IAS 18. 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. Practice has as a result diverged and the IFRIC through D20 is seeking to eliminate that divergence in practice.

Should the deferred revenue approach be applied, or should some other approach be applied instead?

3. The draft Interpretation proposes that award credits of all customer loyalty programmes that fall within its scope should be accounted for as a separate component of a multiple element sale transaction; in other words, that the deferred revenue approach described in paragraph 1(b) above should be applied. We do not support that view, because:

   (a) We believe that the substance of all, or at least the vast majority, of customer loyalty programmes is that of a marketing expense, rather than a sale (see paragraphs 5 and 6 below).

   (b) We do not think it is appropriate for the IFRIC to address a gap in IFRS (as opposed to clarifying existing GAAP) that has the effect of requiring the vast majority of entities affected to change their existing practice and also to adopt a more complex approach without the IFRIC also either at the same or previously developing a framework from which that material can be derived (see paragraphs 7-11 below).

   (c) We are not comfortable with the measurement implications of the specific deferred revenue approach proposed in D20 (see paragraphs 12-13 below).

4. We believe that recognising an expense with a corresponding provision will, in most instances, result in the most appropriate accounting treatment and, until further research is undertaken, will provide the highest level of comparability of information in the financial statements. Accordingly, we support the view discussed in 1(a) above – i.e. that the entity's obligation arising under a loyalty programme should be recognised as an expense at the time of the initial sale and measured by reference to the amount required to settle it, in accordance with IAS 37.

The substance of a loyalty programme

5. Paragraph 1 of D20 states that “customer loyalty programmes are used by entities to provide customers with incentives to buy their products”. We agree. The vast majority of loyalty programmes are viewed by the companies that provide or use them, as a marketing tool, created to enhance customer loyalty and encourage ongoing sales. That is also how the vast majority of their customers view the programmes; the customer does not view their purchase as a purchase of two things, but as a single purchase which makes them eligible for ‘money off’ their next purchase. In our view, when the substance of an activity is that of marketing, the activity’s impact in an accounting sense should be on the expense accounting rather than the revenue accounting.

6. We recognise though that not all loyalty schemes are the same and that as a result they may differ in substance. However, we think the vast majority are as described in the previous paragraph. The value of the credits awarded under customer loyalty programmes is in most cases very low in comparison with the value of the purchases required to earn them, and the granting of the award credits will generally be incidental to the activities of the respective entity.

Separately identifiable components

7. One of our major concerns about what D20 is proposing arises because there is no guidance in IFRS as to what a separately identifiable component is. (We note that one of the objectives of the IASB’s revenue recognition project is to develop such guidance, but we also accept that the fact that there is a long-term project that is addressing the issue should not prevent the IFRIC from providing an ‘interim solution’ that will improve the way IFRS are implemented in the shorter-term.)

8. In our view, if the IFRIC is to address a gap in IFRS, it needs to do it in a principles-based way if it is not to find itself producing one rule-based solution after another to address slightly different circumstances. That, in our view, means developing a set of principles (i.e. a sort of framework) from which more specific solutions can be derived. However, D20 does not clarify a principle that might be used to determine when a transaction should be considered a separately identifiable component. Neither does it clearly articulate the basis on which the segmentation of the transaction should be made. We therefore struggle to understand the reason why the IFRIC concludes that award credits are always separate components of revenue. For instance, it is not clear that there is a difference in principle between goods sold with a ‘normal’ warranty and goods sold with award credits. In a second example, we also struggle to understand the difference between a marketing cost and an award credit.

9. We believe that the draft Interpretation would benefit from additional research on the concept of segmentation of transactions. The lack of a clear set of guidelines on segmentation of revenue transactions might lead to inconsistent accounting practices, when for instance, entities refer to analogous transactions for guidance - paragraph BC31 of the recently approved Interpretation on *Service Concessions Arrangements*, refers to separate elements and states that “….its terms call for separate phases or elements because each separate phase or element has its own distinct skills, requirements and risks”. The “criteria” referred to in the latter might be interpreted differently if it were reflected in the context of award credits. Similarly, we wonder to which extent the limited guidance in BC5 of the Draft Interpretation could be used to interpret other transactions outside of loyalty programmes. We note that in the recent November issue of the IFRIC update, the IFRIC, when discussing the agenda decision on “IAS 11 Constructions Contracts – allocation of profit in a single contract”, stated

that " *… because these issues are being expected to be addressed in an Interpretation following from D20, it would not take this item onto its agenda".* We assume this to mean that the IFRIC believes the "criteria" in D20 are applicable to transactions outside of customer loyalty programmes. Yet the criteria do not even seem to be applied in the recently approved Interpretation on *Service Concessions Arrangements.* This illustrates the problem that arises when a clear set of guidelines on segmentation has not been properly developed.

10. Although we recognise that the scope of the IFRIC is limited to providing guidance on how entities should approach the accounting for customer loyalty programmes (under the existing requirements of IAS 18), we think the call for such guidance demonstrates the importance for more general issues surrounding the accounting for multiple sale arrangements being addressed in the IASB's comprehensive project on revenue recognition.

11. The need for a principles-based approach might be less important were D20 to be doing little more than confirming the practice that is most commonly used, but it is in fact proposing the adoption of an approach that the vast majority of those affected do not use. And it is proposing an approach that is probably more complex than the other approaches available. That does not in itself make it the wrong approach (although, we are for other reasons arguing that it *is* the wrong approach), but it does make it more important to show that the solution is conceptually sound and consistent with the way that analogous transactions are accounted for, rather than simply an ad hoc solution.

Measurement of the obligation

12. As previously noted, we have concerns with the measurement implications of the deferred revenue approach proposed in D20. In particular:

    (a) Paragraph 6 of D20 states that "the allocation (of the total consideration between the separately identifiable components) shall be made by reference to the *relative fair values* of the components, i.e. the amounts for which each component can be sold separately". We note that there are several factors, including "unique features" pertaining to several loyalty programmes, which could result in a need for a significant degree of estimation when determining fair value. This could impair its reliability, perhaps significantly in some areas. Further, we believe the requirement to determine the fair value of each component could be burdensome.

    (b) Paragraph 7 indicates that "the fair value of the award credits may be estimated by reference to the discount that the customer would obtain when redeeming the award credits for goods or services". This seems to suggest that deferred revenue should be measured from the perspective of the customer. Yet we read paragraph 6 as referring to measurement from the perspective of the entity. We note that other standards – for example IAS 18 and IFRS 2 – adopt an entity perspective. We think the underlying principle here needs further thought.

    (c) We believe that D20 fails to take into account the relationship between market demand and customer loyalty programmes. We think that, for some award credits, there might not be a willing buyer available on the market – for instance if the entity grants free or discounted products that otherwise would be scrapped because of inventories being in excess of demand or if the entity grants free airline tickets which are granted only within the boundaries of statistically empty seats. Therefore, we suggest that the IFRIC clarify that usual market prices are not necessarily the relevant reference. For example, assume an airline has a plane with 100 seats. 60 tickets have been sold for CU (currency units) 50 each and statistically at least 30 tickets for the plane will remain unsold. Is the fair value of these tickets (close to) CU 50 or (close to) zero? There are different views on this and it would be helpful if the IFRIC could clarify this.

(d) In our view, the proposals on the accounting for forfeitures and recognition of revenue, as described in paragraphs 7 and 8 of D20 respectively, are complex and unclear (see paragraph 21).

13. A key objective of the IFRIC in issuing D20 is to seek consistency on accounting practices for loyalty programmes. However, for the reasons noted above, we doubt that consistency and comparability will be achieved, if the measurement approach being proposed is adopted.

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. Although we support the IFRIC's efforts to achieve a common approach on accounting for loyalty programmes we strongly believe that the costs of adopting a single approach for all customer loyalty programmes should not exceed the benefits of having such a single approach.

15. Generally,we doubt whether the accounting treatment being proposed in D20 will increase the relevance and reliability of the information presented in the financial statements. We are therefore concerned that the extra burden will provide limited, if any, additional benefits.

Our conclusions on a preferred method

16. 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 should 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). Essentially, we agree with the arguments noted in BC4 in support of the cost/provision approach and we think that recognising an expense in accordance with IAS 37 provides the most appropriate accounting treatment in most instances. Furthermore, we understand that this approach is consistent with that generally applied to similar transactions that are outside the scope of D20. On balance, we 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. We recognise that it could be argued that a small minority of loyalty programmes might be more appropriately accounted for using the deferred recognition approach. However, it would take some time to develop criteria that would enable these programmes to be differentiated from other programmes. For that reason, we think it expedient to apply the cost/provision approach to all loyalty programmes until further research has been undertaken.

Other comments

17. As is now clear, we do not support the approach proposed in D20. However, if the IFRIC were to decide nevertheless to proceed with it, we believe that the following matters should be taken into account.

Scope

18. In our view, customer loyalty programmes should be more closely defined. For instance the interpretation fails to indicate whether it applies to free or discounted goods or services if these goods and services are not marketed separately. For example, airline companies might grant their loyal customers access to their airport lounges or fast-track boarding procedures, irrespective of the class of ticket they are holding, but the access to airline lounges, for instance, is not marketed separately. We believe that no revenue ought to be deferred on this type of service. We encourage the IFRIC to clarify this aspect.

19. Some loyalty programmes include granting award credits to existing and potential customers independently from a sale transaction. For example, welcome bonuses are offered to potential customers when they register as members of the programme irrespective of a sale transaction. Those award credits create for entities a similar performance obligation as might award credits granted with a sale transaction. We encourage the IFRIC to clarify this aspect.

20. D20 does not specifically address sales of awards credits by an entity to another entity. These types of transactions are common practice amongst loyalty programme operators (for example an airliner selling ‘air miles’ to a credit card company) and in practice difficulties can be encountered as to the correct accounting treatment these transactions. We encourage the IFRIC to clarify whether the scope includes sale transactions of award credits by an entity to third parties.

Recognition of revenue and changes in estimates

21. D20 paragraph 8 states that: “The entity shall recognise revenue of the award credits either:

    (a) in the periods, and reflecting the pattern, in which award credits are redeemed; or

    (b) if a third party assumes the obligation to supply the awards to the customer, when the third party assumes the obligation.

    The amount of revenue recognised in (a) will be based on the number of ward credits that have been redeemed relative to the total number expected to be redeemed”.

    Paragraph 8 is best explained in BC 11 and BC 12 of the Basis for Conclusion, which suggests that the amount of revenue allocated to award credits is fixed at the date of the initial sale transaction. However, the Draft Interpretation does not explain how to account for factors that, once the awards have been issued, affect the probability of outstanding award credits not being redeemed. For instance, after an award is granted, an entity might obtain reliable evidence that the probability of an award being redeemed is remote. The following simple example illustrates our concern:

    At the beginning of year 1, an entity receives a total consideration of CU (currency units) 10.000 and awards a customer 100 awards to be redeemed in the future. The entity expects that only 90 awards will be redeemed, with 30 awards being redeemed over the next three years. The entity allocates CU 9.100 to the sales transaction (delivered component) and CU 900 to the award credits, therefore deferring CU 900 of revenue. The allocation is based on a fair value of CU 10 being allocated to each award credit.

    At the end of year 1, no awards have been redeemed. Furthermore, the entity re-assesses the redemption rate and now expects only 80 awards to be redeemed over the next two years. Following paragraph 8 of D20, it seems that no revenue should be recognised in year 1 – because no awards were redeemed in that period. However, this is inconsistent with the requirement that redemption should reflect “the pattern, in which award credits are redeemed”. Furthermore, the balance in deferred revenue amounts to CU 900, whereas only CU 800 (80 awards* CU 10) is needed to meet the obligation for future redemptions. It is unclear how to treat the difference of CU 100. We recommend that the IFRIC provide further clarification including illustrative examples on how subsequent changes in estimates are accounted for, including the recognition of deferred revenue when award credits have lapsed or are no longer expected to be redeemed.

22. Paragraph 10 (explained in BC 12) proposes that revisions to the ‘initially expected forfeiture rates’ be accounted for in accordance with the guidance applied to onerous contracts as discussed in IAS 37. We believe that the draft Interpretation would benefit extensively from including an example to illustrate the proposal in paragraph 10.

Effective date and transitional requirements

23. We agree that the requirements of D20 should be applied retrospectively. Our conclusion is based on the premise that we support the general principle that all new Interpretations and new or revised IFRSs should be applied retrospectively.