EFRAG
European Financial Reporting Advisory Group

The costs and benefits of implementing IFRIC 13 *Customer Loyalty Programmes* in the EU

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of IFRIC 13 *Customer Loyalty Programmes*.

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. In the case of IFRIC 13, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a public consultation on the costs and benefits and supplementing that consultation with a small amount of additional work in the form of direct consultation with some preparers who would have to change their accounting to comply with IFRIC 13. Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing IFRIC 13 in the EU, to consult on the results of those initial assessments, to discuss directly with a limited number of affected preparers the impact IFRIC 13 would have on the preparation of their financial statements and the amount of effort implementation would require from them, and to finalise those assessments in the light of the comments and information received.

EFRAG's endorsement advice

3 EFRAG already carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria, and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this Effects Study Report into account in finalising its endorsement advice.

Description of IFRIC 13

4 Many entities operate schemes that are designed to encourage those who buy their goods or services to buy further goods or services from them. These customer loyalty programmes can take many different forms.

5 There are differing views as to how to account for one particular type of customer loyalty programme: a programme that involves granting points, air miles or other credits ('award credits') to a customer at the time of a sales transaction, which can be redeemed subsequently to purchase goods and services from that same entity or another entity free or at a discounted price.

(a) Some entities have been interpreting IFRS as requiring the initial transaction to be treated as having both the sale of the goods or services and the sale of award credits. Therefore, sales consideration will be allocated between the two components and a profit or loss on each component will arise depending on whether the revenue allocated to the component exceeds the costs involved. The profit on the sale of award credits will not be recognised immediately; rather it will be recognised when the award credits are redeemed.

(b) Some entities have been interpreting IFRS as requiring the initial transaction to be treated as having a single component (the sale of the goods or services) and the cost of meeting the credits granted will be just one of the costs of that single component transaction.

These different treatments will result in profit being recognised in different periods (the total profit will in the end be the same) and different amounts of liabilities being recognised in the balance sheet.

6 IFRIC 13 is intended to eliminate this inconsistency. IFRIC 13 states that approach (a) above is the correct interpretation of IFRS. It then goes on to provide guidance on how the approach should be implemented. In particular it explains that:

(a) The fair value of the total consideration receivable should be allocated between the award credits and the other components of the transaction.

(b) The allocation of the consideration to the award credits is by reference to the fair value of the award credits, i.e. the amount for which the award credits could be sold separately (an exit value).

(c) The consideration allocated to the award credits is recognised as revenue when the award credits are redeemed and the entity's obligation to supply the award credits is fulfilled. Until then, it is recognised as a liability (for payments received in advance) on the balance sheet.

EFRAG's initial analysis of the costs and benefits of IFRIC 13 and Stakeholders' views on it

7 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing IFRIC 13, both in year one and in subsequent years.

8 On the basis of that initial assessment, EFRAG tentatively concluded that IFRIC 13 will improve the quality of the financial information provided and, as such, that its implementation will benefit users.

9 EFRAG further tentatively concluded that IFRIC 13 will involve preparers and users in incurring different levels of cost depending upon how closely entities' current approach is to that required by IFRIC 13. EFRAG believed, in particular, that the adoption of IFRIC 13 will:

(a) involve all preparers incurring some year-one costs—in order to read, understand and implement the new requirements retrospectively—but those costs will be not be significant except as described at (b) below;

(b) involve some of those preparers that currently use the cost-provisioning approach incurring significant costs to modify or create appropriate systems in year one;

(c) involve many preparers incurring incremental ongoing costs, although those costs will not be significant; and

(d) involve users incurring only insignificant incremental year-one, and no incremental ongoing, costs.

10 Finally, EFRAG tentatively concluded that the benefits expected to arise from applying IFRIC 13 were likely to exceed the costs involved in its implementation.

11 EFRAG published its initial assessment and supporting analysis on 14 March 2008. It invited comments on the material by 14 April 2008. The results of this consultation can be summarised as follows. Where specific responses to the questions posed were provided by respondents:

(a) All respondents agreed with EFRAG's assessment of the costs involved for users and preparers. As discussed in paragraph 13 below, comments from preparers consulted directly were also generally consistent with EFRAG's assessment.

(b) All respondents agreed with EFRAG's assessment of the benefits associated with implementing the Interpretation.

(c) All respondents agreed with EFRAG's conclusion that the benefits to be derived from IFRIC 13's application will exceed the costs involved.

12 In addition, EFRAG consulted its User Panel in March 2008 on the impact that IFRIC 13 would have on users. Panel members were generally supportive of the Interpretation because it reduces divergence in practice, although some members did point out that the approaches used to estimate fair value might not be fully consistent between companies. Additionally, members thought the costs for users arising from the Interpretation would be very small, both initially and in the future.

13 Finally, concurrently with the public consultation, EFRAG interviewed a small number of preparers who are currently assessing their approach to the implementation of IFRIC 13 for their customer loyalty programmes. These discussions provided information generally consistent with EFRAG's initial assessment of the costs that would be incurred by preparers. The main difficulties faced by preparers are that of arriving at a reliable fair value in the absence of an observable market for award credits, and that of determining how to identify the fair values of awards redeemed when fair values change from year to year. Preparers have developed tentative methodologies for estimating fair values based on a number of variables and supportable assumptions, and for the identification of the specific fair values of redemptions based on observed customer behaviour. These methodologies have been time-consuming to develop but are expected to be less onerous to maintain, and the overall cost of implementation is not considered by preparers to be significant in the context of their operations. There appears to be very little modification required to systems. Finally, EFRAG noted that the interviews with preparers bore out EFRAG's

comment in its endorsement advice and the comment from the EFRAG User Panel that there might be a diversity of approaches to estimating the fair value of award credits.

EFRAG's final analysis of the costs and benefits of IFRIC 13

14 Based on its initial analysis and the stakeholders' views on that analysis, and the information obtained from preparers who are developing their implementation plans, EFRAG's detailed final analysis of the costs and benefits of IFRIC 13 is presented in the paragraphs below.

15 EFRAG has concluded, for the reasons explained in our Endorsement Advice, that the interpretation set out in IFRIC 13 will reduce uncertainty about how to account for customer loyalty programmes and consequently result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

16 EFRAG considered whether applying the accounting treatment required by IFRIC 13 would involve significant incremental costs for preparers. Implementing IFRIC 13 will involve some year-one work and some ongoing work. The extent of that work is dependent upon the entity's current degree of compliance with the accounting treatment required by IFRIC 13, but will involve some or all of the following.

(a) The year-one work will involve reading and understanding IFRIC 13 and ensuring that it is implemented correctly. This will include the restatement of the earliest prior periods presented in the financial statements as IFRIC 13 is to be applied retrospectively. If the necessary procedures and systems are not already in place, that will include designing procedures and modifying or creating systems that will allow entities to:

   (i) estimate the fair value of award credits by reference to the amount for which they could be sold separately;

   (ii) estimate the total number of award credits expected to be redeemed;

   (iii) calculate and record the amount of revenue to be deferred; and

   (iv) track the granting and redemption of award credits and the related fair values.

(b) The ongoing work will involve:

   (i) estimating the fair values of the award credits;

   (ii) estimating, and re-assessing the appropriateness of, the redemption rates to be applied;

   (iii) tracking the granting and redemption of award credits and the related fair values; and

   (iv) calculating the appropriate amounts of revenue to be deferred and to be recognised in the income statement.

17 Of course, some companies will already be following the accounting treatment described in IFRIC 13 exactly. However, many companies with customer loyalty

programmes within the scope of IFRIC 13 will not be. Instead they will either be applying a variant of the accounting required by IFRIC 13 or will be treating the sales transaction as involving just a single component and, as a result, providing for the cost of awards.

Year-one costs

18 In the case of entities already applying a variant of IFRIC 13 (in other words, already applying paragraph 13 of IAS 18 to customer loyalty programmes), EFRAG believes that the main changes are likely to be how the sale consideration is allocated between the main sale and the sale of award credits and how the revenue is recognised based upon actual and expected redemption rates. The examples given in IFRIC 13 indicate that simplifying approaches and estimates are acceptable and the evidence EFRAG has suggests that the costs of adapting to a fully compliant approach would not be significant. Consequently, its view is that the additional costs involved will in most cases not be significant.

19 In the case of entities that have been treating the sales transaction as involving just a single component, many will already have a system that allows them to track the numbers of award credits outstanding and to estimate the redemption rates in order to be able to accrue for the cost of fulfilling their obligations. What may be new is the need for a methodology to arrive at an estimate of fair value for the award credits and a system which will facilitate the tracking of the fair values of the award credits which are expected to be redeemed. Developing this methodology and system will involve year-one costs.

20 EFRAG's assessment is that this will not involve significant costs for most preparers because of the simplifying approaches and estimates available to mitigate the costs for companies; however, for some the costs may be significant because it might be necessary to link award-tracking systems to revenue-accounting systems, particularly where there are large numbers of transactions.

21 As mentioned above, IFRIC 13 is to be applied retrospectively. This involves the entity in arriving at a fair value for the award credits at a time when no methodology was in place and the necessary information may no longer be available. In theory this could be quite an extensive exercise. However, EFRAG believes that it will often be possible to apply simplified methodologies and make approximations. As a result, its assessment is that, across all preparers as a whole, the year-one costs will not be significant.

Ongoing costs

22 EFRAG believes that, once the necessary systems and procedures have been put in place by preparers, the ongoing incremental costs are unlikely to be significantly higher than the costs being incurred currently.

Costs for users

23 EFRAG also considered whether the requirements of IFRIC 13 will in some way increase the burden on users of financial statements. Its view is that they impose no additional ongoing burden on users, although some insignificant year-one costs might arise in understanding the changes that many companies will have made to their accounting.

Conclusion

24 EFRAG's overall assessment is that:

(a) implementing IFRIC 13 will result in some year-one costs and some incremental ongoing costs for preparers. For entities already using a variant of IFRIC 13, the initial costs of implementation and subsequent recurring costs are not expected to be significant. For some entities which currently use the cost-provisioning approach, EFRAG believes the initial modification or creation of appropriate systems could involve significant costs, although for others EFRAG believes the adaptation of the estimates currently used for cost provisioning would not involve significant costs. In addition, it will involve users incurring only minimal incremental year-one or ongoing costs;

(b) IFRIC 13 will reduce uncertainty as to how to implement aspects of IAS 18 and will as a result reduce divergence in practice and enhance consistency and comparability of the information provided, thereby benefiting all stakeholders; and

(c) Although the incremental costs of applying IFRIC 13 may be significant for some companies, when viewed as a whole the benefits derived from IFRIC 13 are likely to outweigh the costs that will arise from its implementation.

25 During its consultation process, EFRAG did not become aware of any factors other than those mentioned in this report that should be taken into account in assessing the costs and benefits of implementing IFRIC 13 in the EU.

EFRAG
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