

IFRS Alert

A supplement to Global EYE on IFRS

ERNST & YOUNG

Quality In Everything We Do

IFRIC Draft Interpretation D20 – Customer Loyalty Programmes

Background

Many entities use customer loyalty programmes to reward customers for past purchases and to provide incentives for customers to make further purchases. Typically, schemes grant loyalty awards (such as points or air miles) to customers based on the goods or services purchased. The loyalty awards can be accumulated and used to obtain free or discounted goods and services that may be given by the entity themselves or by other third parties. Such award schemes are commonly seen in the retail, hotel, telecommunications and airline industries.

The IFRIC Draft Interpretation D20 proposes how such loyalty awards should be recognised and measured by entities that operate or participate in such programmes for their customers.

Summary of the proposed Interpretation

Recognition

- The Draft Interpretation proposes that entities shall apply paragraph 13 of IAS 18 and account for the loyalty awards as a separate component of the sales transaction for which they are granted. This component of the consideration received is then deferred until the loyalty awards are redeemed by the customer or the obligation is taken over by a third party.

Measurement

- It is proposed that consideration is allocated to these components by reference to their relative fair values (ie, the goods or services purchased and the loyalty awards granted). This means fair values of both components must be determined. The Draft Interpretation suggests one way in which the fair value of the loyalty awards may be estimated – by reference to the discount that the customer would obtain when redeeming the loyalty awards for goods and services reduced by:
 - (a) discounts that would otherwise normally be granted to customers;
 - (b) the proportion of loyalty awards expected to be forfeited; and
 - (c) the time value of money, based on when the awards are expected to be redeemed.

© 2006 Ernst & Young EYGM.
All Rights Reserved.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

Job No. 10618 09/06. Designed by Living Designs, London

IFRIC Draft Interpretation D20 – Customer Loyalty Programmes... Continued

- Other acceptable measurement methods have not been discussed in the Draft Interpretation but it would be expected that they take into account the same adjustment factors.
- In loyalty programmes where customers can choose from a range of awards, the fair value of the loyalty awards must reflect the range of fair values of the awards that may be chosen, based on the proportion in which the customers are expected to select them.
- In determining the fair value of the loyalty awards, entities will make a number of estimates regarding the proportion of loyalty awards expected to be forfeited, the choice of awards that customers may make and the periods in which awards are expected to be redeemed. Where these estimates are revised at a future date, revenue recognised and the deferred revenue are not adjusted. Instead entities consider how the change in estimates will affect the costs the entity expects to incur to supply the awards and meet their obligation.
- Where the cost of meeting the obligation to supply the awards exceeds the consideration deferred (plus any consideration to be paid when they are redeemed), the entity has an onerous contract and a liability must be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- Customer loyalty programmes may also create or enhance customer relationships. Such relationships are recognised as intangible assets only if they meet the criteria of IAS 38 *Intangible Assets*.

Impact

There is currently considerable diversity in practice for accounting for loyalty awards. The proposals in this Draft Interpretation may therefore reduce revenue in entities that have recognised these as costs. Entities will need to determine a method of estimating the fair value of the loyalty awards, considering the fair value of the free or discounted goods or services that customers can claim, adjusting for the expected levels of forfeiture, the choice of awards made by customers and the period in which the awards are expected to be redeemed. Obtaining this information may present practical difficulties for entities as considerable records will need to be maintained to ensure all the relevant information is collated on a timely basis.

Comment Period:

The IASB has requested comments on the draft interpretation to be submitted by 6 November 2006.