Accounting for Customer Loyalty Programmes – IFRS Perspective

Customer loyalty points have become a very popular practice adopted by various businesses to attract customers and increase their turnover. However, there have been widespread accounting practices prevalent across different companies and industries. IASB sought to bring about uniformity among the practices and developed a guidance in the form of IFRIC 13 mandating certain guidelines to be followed. An attempt has been made in this article to explain the accounting treatment for different types of these programmes and the factors that go into the quantification of the amounts.

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The advent of capitalistic ideology in the West has put an end to monopolies and oligopolies in which one or few players controlled the industry. Barring a very few, all the industries and sectors of the economy have become fiercely competitive with the lack of entry barriers. However, the product or service offers have been more or less homogenous and this has resulted in a paradigm shift in marketing strategies from product differentiation to customer service and retention. Companies started looking for newer ways of acquiring and retaining the customers. The concept was that it is cheaper to retain an existing customer than acquiring a new one. This has led to the practice of incentivising the customers to return for a repeat business.

Customer loyalty points originated in 1950s but has been started in the modern form by American Airlines in 1981 and now has become a very popular practice adopted by various businesses like airlines, credit cards, telecom operators, retailers, hotels, fuel outlets, etc to attract customers and increase their turnover. The arrangements range from simply offering discounts or free goods on further purchases to very complex arrangements that offer goods and services of third parties and participating in programmes sponsored by a third party for the entity's customers. This naturally calls for change in accounting practices to be in line with the nature of the agreement. The estimation of the value attributable to the points, probability of redemption, expiry of the points all have to be given due consideration in quantification of the charge for the period and the future liability to be recognised in the entity's financial statements.

Industry accounting practices varied widely in the quantification of charge and disclosure of liabilities in respect of the loyalty points. Some companies have recognised as liability the cost of providing the free goods or services in the future, some others identified a part of the revenue and deferred it to a later point of time

to be recognised when the points are redeemed by the customers, yet some others have recognised full value of the sale consideration and treated the cost of loyalty points as a marketing expense. Even to this date differences exist between USGAAP and IFRS on this issue.

To address the divergent accounting practices and bring about convergence and uniformity in the accounting and reporting practices about loyalty points across, the IFRS has in 2007 for the first time issued guidance on this aspect, which was later amendment as a part of the IFRS Annual Improvement Plan in 2010. This is applicable for accounting periods beginning on or after 1st July 2008. Objections have been raised from the industry on the exposure draft that the process is complicated, the information is not so relevant and the costs of compliance exceed the benefits that arise on implementation. The committee opined that the certain initial costs will have to be incurred to put the system in place but the ongoing costs will not be significant to exceed the benefits.

It covers any kind of a customer reward programme wherein rewards are offered to the customers with a link to the sales transaction. Any vouchers issued to the general public or in a newspaper coupon entitling discounts are not covered as there is no nexus to any sales transaction.

IFRIC 13 in essence splits the agreement into multiple elements/transactions. It mandates for the sale consideration to be allocated between the goods or services delivered and the points that will be redeemed in future. The interpretation has also given a new dimension to the quantification of liability by prescribing that the measurement has to be done on fair value basis. Fair value is the value that can be realised if the points were sold separately. The entity has to arrive at the fair value of each point and defer the revenue to the extent of the fair value of the points from the sale consideration to a future period when the points will be redeemed. The amount so carried forward in the balance sheet has to be presented as deferred revenues.

The split into multiple deliverables is based on the premise that from the customers standpoint his purchase will entitle him to two things – firstly the goods in the current transaction and also that he has bought a right to get free or concessional goods at a future point in time. Hence, a portion of the consideration should be taken only when second sale takes place i.e. when the rights are exercised by redeeming the points. This point was specified by IASB in its basis for conclusion while issuing the IFRIC that a marketing cost is one which is made independent of a sales transaction and any other incentive that is offered to a customer as a part of the sales transaction has to be deducted from revenues.

The test as to whether to defer the revenue or not can be taken as whether the incentive is given as a part of the sales transaction or separately. If there is a nexus between the sale transaction and the reward, deferral has to be done.

The entity can recognise the revenues thus deferred only after any one of the following conditions is met.

1. The credit points are redeemed by the customer.
2. The points issued by the entity lapse (normally points have time limit for redemption).
3. The obligation is passed on to another entity and an amount is paid for the outstanding points.
4. The entity expects that there is a very remote possibility of the redemption by customers.

Fair value of the points granted must be estimated in most cases and are not readily available as most companies don't sell points separately, and this calculation sometimes can get difficult based on the complexity and flexibility that the programmes offer. For example in case of airlines, passengers flying a particular route may get certain number of miles but the fair value calculation can get complicated for the reason that the number of miles accrued by passengers varies based on the relationship of the passenger (ex frequent flyer, gold, silver member, etc), the class of travel (business, first class, economy), the fare scheme (flexi fare, promotional offers, etc), hence there are a lot of factors that go into the calculation of the fair value. So in case of airlines the fair value is calculated based on the yield that the company gets on a class and sector of travel.

Fair value has to take into account whether the any discounts are offered to new customers who don't have any reward points. If discounts are offered in normal course then the fair value will be the amount net of the discount offered. Also the fair value will depend on the popularity of the goods/services. IFRIC 13 does not specify the mode of calculation or estimation of fair value of the reward credits, however it mandates that the fair value has to be from the perspective of the customer and not the cost that the company will incur to provide the free/concessional goods and services. However as a part of its 2010 Improvements programme, it has given guidance that the fair value of the award credits should take into account the expected forfeitures and discounts that would offered even to customers who have not earned award credits.

Reward points fall into different categories and some of the most popular forms are:

1. Award of points to the customer for free/discounted goods/services from the same entity. (Air miles issued by airlines/fuel stations)
2. Award points to the customer which can be redeemed at other entities. (Ex Credit card points)
3. Award of points in a programme administered by a third party.

The accounting treatment for each of the above will be different having regard to the nature of the arrangement.

Example: A supermarket provides 1 reward point for every ₹100 of purchases made, and on accumulation of 1000 points the customer can redeem these

points for discount at ₹1 per point. Assume that customers buy goods worth ₹22 lakh during the Year 1, ₹30 lakh in Year 2 and ₹40 lakh in Year 3. The reward points are valid only till the end of next year following the year of purchase. Also the company expects that only 65% of the customers will attain eligibility of 100 points and 90% of those who attain eligibility will redeem the points before the validity date. In Year 2 ₹18 thousand and in Year 3, 20 thousand reward points have been redeemed. Based on the higher redemptions, the company in Year 3 changed the assumption to make that 80% of the subscribers reach the eligibility and 100% of those eligible will redeem the points.

Year 1

Value of the sales consideration	:	₹22.00
Fair Value of reward liability @₹1	:	₹0.13
Revenue to be recognised	:	₹21.87

Accounting Entry		
Cash	**Dr**	**22.00**
Sales	**Cr**	**21.87**
Deferred Rev	**Cr**	**0.13**

Liability ₹ = (₹ (22,00,000)/100)= ₹22,000x0.65 (Customers reaching 100 points)x0.9 (percentage of eligible customers opting for redemption) = 0.13 lakh. The quantification of the revenue to be deferred is always a best estimate at the end of the accounting period and IAS 37 allows the application of probabilities for measurement, however these have to be realistic.

Year 2

Particulars	**₹Lakh**
Sale Consideration (A)	30.00
Fair value of reward points to be deferred (B)	0.18
Revenue to be recognised (C) = (A-B)	29.82
Redemptions of Year 1 Points (D)	0.18
Reclass of revenue from defered to sales (E)	0.13
Shortfall in defered revenue (F) = (D-E)	0.05
Sales revenue for Year 2 net of adjustment C-F	29.77

Accounting Entry		
Cash	**Dr**	**29.82**
Deferred Revenue	**Dr**	**0.13**
(For points redeemed)		
Sales	**Cr**	**29.77**
Deferred Revenue	**Cr**	**0.18**
(Liability for sales in year 2)		

Note: Cash received will be ₹29.82 lakh as the balance 0.18 lakh is due to redemption of loyalty points

The estimates of the company were off as in Year 2 the redemptions exceeded the deferral of revenue in Year 1 and has impacted the revenue of Year 2 to the extent of ₹0.05 lakh. Hence, the company in Year 3 changed its assumptions on probability and worked out as under. The change in estimates of redemption have to be accounted as change in estimate in accordance with Para 36 of *IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors*

Year 3

Particulars	**₹Lakh**
Sale consideration	40.00
Fair value of reward points	0.32
Revenue to be recognised	39.68
Redemptions	0.15
Value of liability from Year 2	0.18
Value of points from year 2 lapsing	0.03

Accounting Entry		
Cash	**Dr**	**39.85**
Deferred Revenue	**Dr**	**0.15**
(For points redeemed)		
Sales	**Cr**	**39.68**
Deferred Revenue	**Cr**	**0.32**
(Liability for sales in year 3)		

Entry (For lapsed points in Y3)		
Deferred Rev	**Dr**	**0.03**
Sales	**Cr**	**0.03**

Value of reward points = ₹40 lakh x 0.8 (percentage of customers reaching eligibility of 1000 points for encashment)

Out of ₹18 lakh points issued in Year 2 only 15 lakh were redeemed and the remaining 3 lakh expire and can be taken to revenues.

Entities adopting IFRIC 13 need to consciously take into consideration the facts of the loyalty program and assess the fair values, redemption rates, customer behaviours, etc. Information is to be tracked at any given point of time for the number of points outstanding and those lapsing, when any changes are made in the plans, the entire liability needs to be reworked.

Redemptions Involving Another Company

There are another type of reward points programmes which most companies in service sectors offer and these include airline, hospitality, etc. The agreements are in such a way like if a passenger flies an airline or a customer spends certain amount on credit card air miles are earned, which can be redeemed with any of the partner airlines, or can be used for car rentals, staying at a particular hotel free of cost or concessional rate for a particular number of nights, etc. Essentially the entity entitles the customer to

goods or services from other providers and thus increasing the utility of the points for the customer.

In most of the agreements of the above nature, the point redeeming company provides the services free of cost or reduced rate and then recovers from the company that gives the points to its customers. In this case at the time of transaction the card point issuing company will recognise the revenue in full as the company does not have an obligation to provide the services any further, and then provide for the amount payable to the points redeeming company for the liability. The companies generally agree in advance on the amount to be paid per point hence quantification of deferral is relatively easier. Consideration has to be given as to whether the issuer of points is acting as a principal or as an agent of the redeeming company and to this extent the IAS 18 consideration of gross vs. net revenue reporting apply.

Example: An airline issues points which can be redeemed with a car rental company; car can be taken free of rent 1 day for every 1000 points. The airline gives 1 point for every ₹100 spent. Airline pays the car rental company ₹0.8 for each point. In a given year the airline issues 10 lakh points. In this case the airline recognises the total consideration as it has no further liability and provides ₹8 lakh as liability to the car rental company. However, if in the case the points can be redeemed both at the airline and the car rental company then the airline cannot recoginse the complete revenue as the airline still has the liability to provide services. Revenue to the extent of fair value of the points has to be deferred.

Third Party Programmes

Another type of rewards programme can be a case where the third party provider known as programme sponsor operates an independent programme and different companies take part in the programme. The individual companies purchase points from the point issuing company and give the credit to their customers.

The value of the points will be agreed in advance and this will make it simpler for companies in accounting. Once the company pays the programme sponsoring company for the points issued there is no further liability. The company redeeming the points will claim the amount from the programme sponsor. In effect the programme sponsor acts as an intermediary for settlement of the points and charges commission for the activity.

Example: Company XYZ administers a reward point programme in which airlines, hotels, credit card companies and car rental companies take part. 1 point earned in any of these companies can be redeemed at the other companies. The company A sells 1 point for ₹1 each to the participating companies and pays ₹0.8 to the redeeming companies earning a margin of ₹0.2 for each point redeemed.

A hotel issues 1 point for every Rs 100 spent and on acquiring 1000 points the customer can redeem them with any of the participating companies. During the year the company issues 5 lakh points for a spend of ₹5 crore to its customers. Assuming that the hotel is acting as an intermediary and the just bills and passes this revenue to XYZ and in effect increases its market, the entries will be as follows. The revenue is taken as per IAS 18.

At the time of issuing the points.

		(₹Lakh)
Bank	Dr	500.00
Sales Revenue	Cr	495.00
Liability to XYZ	Cr	5.00

Settlement of Liability

		(₹Lakh)
Liability to XYZ	Dr	5.00
Bank	Cr	5.00
(Payment by hotel to XYZ for the points)		

Assume that out of the 5 lakh points above, the customers redeem 2 lakhs points with an airline company for free tickets. The airline company will make the following entries in its books:

		(₹Lakh)
Receivable from XYZ	Dr	1.60
Revenue	Cr	1.60

Note: The revenue for airline will be ₹1.6 lakh as the company XYZ which settles the points will pay only ₹0.8 to the redeeming company per point. 2 lakh points will give revenue of ₹1.6 lakh

Factors Influencing the Quantification of Deferred Revenues

1. ***Fair value:*** This is perhaps the most important component and forms the basis for quantification of the amount. Changes in the fair value and the assumptions used in arriving at it significantly impact the deferral. The company needs to lay down the methodology to be adopted in calculation and has to be consistent in its usage to avoid fluctuations across different reporting periods; It will be a better practice to disclose in brief the basis for calculation. For example the German airline Lufthansa which reports in IFRS, in its annual report for 2010 for bonus miles programme notes that "Fair value is determined as the value for which miles could be sold separately, i.e. the average yield, taking booking class and traffic region into account".
2. ***Requirements for redemption:*** This is important for the fact that it influences the redemption rate. Normally there is always a certain percentage of points which will never get redeemed as the customers don't meet the mandated requirement. This factor, say 80% or 90%

redemption, is factored in calculation of the revenue to be deferred and is reviewed annually to be adjusted based on experience. A low requirement threshold will increase the level of redemptions and the company will have to increase the deferral amount, the converse is true in case of a higher requirement threshold.

3. ***Other factors:*** Popularity of the programme or the goods or service, past experience of the company on redemption rates. (If the company lacks historical data on redemption rates then 100% of the points have to be considered). Changes in the features of the plan, validity term of the reward points, etc.

Other Considerations

1. IFRIC 13 does not consider the time value of money in the quantification of the revenue to be deferred as it will not be material in majority of the cases.
2. Reward programmes may sometimes build brand image or customer relationship, no intangible asset comes into existence as a result of this unless the recognition criteria of IAS 38 – *Intangible Assets* is met.

Indian Perspective under the Ind AS 18

In the wake of convergence of the Indian Accounting standards with the IFRS, a clear guidance for the recognition of the revenue on the customer loyalty programmes has been given for the first time by incorporating the requirements of IFRIC 13 as an annexure to the new standard Ind AS 18–Revenue. The Ind AS 18 is a comprehensive standard that brings all the guidance prescribed under IFRS concerning revenue into one standard. The guidance given in Annexure B to the new standard is exactly in line with requirements specified in IFRIC 13 and can be considered a replica of the latter pronouncement.

Paragraph 13, of the standard lays down the first step of the accounting practice to be followed, specifying that an entity shall apply the recognition criteria to separately identifiable components of a single transaction in order to reflect the substance of the transaction. Hence the any transaction in which loyalty points are a part, giving the customer a future right is viewed as two transactions (a sale & a right for future). Post the split of the transaction as required under para 13, detailed guidance has been specified in Annexure B to the standard. The fair value of the award credits attributable to the reward points has to be calculated and deferred to be recognised at a later date when the points are redeemed or extinguished.

Although extremely rare, there may be times where the expected cost of the obligation under the loyalty points is higher than the revenue deferred at the time of the initial sale and the additional consideration if any receivable on redemption. This creates an onerous contract, in which case a provision for the costs as they are excess of the revenues has to be provided for in accordance with the Ind AS 37-*Provisions, Contingent Liabilities and Contingent Assets*.

Treatment under USGAAP

The Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) considered the issue of loyalty points in the year 2000. As a part of the issue 00-22 "Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future" five issues have come up for consideration by the task force. An agreement was reached by the members on only one issue on how a vendor should account for an offer to a customer to rebate or refund a specified amount of cash and which is redeemable only when the customer a specified cumulative level of transactions yielding revenue or has been a customer for a specified period of time. This was later codified in the EITF 01-09 (ASC 605-50-45-2).

As a result of failing to arrive at a consensus on the issue of loyalty points there exist divergent practices in USGAAP for accounting for the loyalty programmes. Companies may use EITF 00-21 (the pronouncement dealing with multiple deliverables), its successor EITF 08-1 (ASC 605-25) or the incremental cost model or even IFRIC 13. For example Delta Airlines having $4.5 billion deferred revenue for air miles, in its 2010 Annual financial filing, mentions that residual method is used in revenue recognition of mileage credits, wherein a portion of the mileage credits equal to the fair value based on the prices at which credits are sold to other airlines, is deferred and recognised when the related services are provided. This has been calculated at $0.0054 per mile, the portion of revenue received in excess of mileage credits sold is recognised as other revenues when the marketing services are provided for the sale. Also in case of the miles that are not expected to be redeemed the value associated is recognised proportionately during the period in which the remaining miles are expected to be redeemed.

Conclusion

The underlying concept of IFRIC 13 is that loyalty points are not costs that relate to the goods sold or services already provided, but they are separate goods or services to be delivered at a later point of time. Hence it is inappropriate to recognise the revenue upfront and deferral has to be done. IASB has thus brought about standardisation in the accounting practice in yet another area where different accounting treatments have been prevalent. As economies grow and services sector becomes more competitive and play a major part in the GDP, companies will come out with newer ways of incentivising customers to stay with them and a major tool in this will be the loyalty points. This step taken by IASB goes a long way in standardising the accounting practice and perhaps in future even USGAAP may adopt this pronouncement. ■