Australian Government

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Mr Robert Garnett
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30 Cannon Street
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Dear Bob

**IFRIC Draft Interpretation D20**
***Customer Loyalty Programmes***

The Australian Accounting Standards Board (AASB) has considered the proposals in IFRIC Draft Interpretation D20 and is pleased to provide its views in respect of the proposals for consideration by the IFRIC.

*Support for the Key Proposals of the Draft Interpretation*

The AASB agrees with the proposal in D20 that award credits should be accounted for as a separately identifiable component of the sales transaction in which they are granted (the "initial sale") in accordance with paragraph 13 of IAS 18 *Revenue*.

The AASB also agrees with the proposal in D20 that the fair value of the consideration received or receivable in respect of the initial sale should be allocated between the identifiable components of the initial sale by reference to the relative fair values of the components.

The AASB generally agrees with the proposal that an entity should recognise revenue in respect of 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 that third party assumes the obligation.

However, in relation to the frequent circumstances in which a third party supplies awards on behalf of a reporting entity, the AASB is of the view that the Interpretation should address whether the reporting entity should treat the gross consideration attributable to the award credits as revenue (see paragraph BC14 of the Basis for Conclusions on D20).

Such guidance alternatively could be included in another Interpretation issued concurrently.

The AASB has the following proposals for amending the Draft Interpretation.

*Measuring Award Credits at Fair Value*

*Amounts paid to third party suppliers of awards*

Paragraph BC10 of the Basis for Conclusions says that, instead of using the estimation process in paragraph 7 of the draft Consensus, an entity may use other techniques for estimating the fair value of award credits. As an example, it says that if third parties are engaged to supply awards, an entity could use the amount paid to the third party supplier of awards for each award credit it grants, plus a reasonable profit margin.

The AASB doubts that an entity could determine reliably a reasonable profit margin between:

(a) the price it would pay a third party to assume an obligation to deliver award credits (an exit value); and

(b) the price (consideration) paid by the customer to acquire the award credits (an entry value),

unless the entity sells award credits separately to customers.

This is because:

(a) estimating profit margins requires comparing historical entry and exit values for a given item and making appropriate adjustments for changes in market conditions; but

(b) historical entry values will seldom be observable for award credits because they seldom are sold separately to customers.

Therefore, the AASB considers that the abovementioned guidance in paragraph BC10 should only be used to estimate the relative fair value of award credits when the entity sells award credits separately to customers.

*Contradictory guidance in the Appendix to IAS 18*

Paragraph 11 of the Appendix to IAS 18 says that when the selling price of a product includes an identifiable amount for subsequent servicing, the amount of deferred revenue in respect of the subsequent servicing is that which will cover the expected costs of those services plus a reasonable profit on those services. It would seem logical to analogise from this measurement of subsequent servicing revenue to the measurement of award credits, because both items are separately identifiable components of an "initial sale". However, paragraph 9 of IAS 18 requires revenue to be measured at the fair value of the consideration received or receivable. This amount is an entry value, whereas the amount mentioned in paragraph 11 of the Appendix to IAS 18 includes (or is) an exit value. For a given contract, those amounts might be the same, but only by coincidence.

The AASB is concerned that paragraph 11 of the Appendix to IAS 18 does not support the proposal in D20 that the amount of revenue attributed to award credits should be the fair value of the consideration received for them (paragraph BC8). It observes that the Appendix to IAS 18 is not part of that Standard, but nonetheless considers that the Interpretation should clarify the apparent contradiction between IAS 18 and paragraph 11 of the Appendix.

*Scope of the Interpretation*

The AASB observes that paragraph 3 of D20 indicates that the Draft Interpretation applies to award credits that customers can redeem for free or discounted goods or services. However, it does not specifically indicate whether its scope includes award credits that the customer has an unconditional option to redeem for either cash or goods and services. The AASB considers that the Interpretation should clarify this matter, because if the customer holds such an option, the liability for award credits would be a financial liability to be accounted for under IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, rather than under IAS 18. Paragraph 19 of IAS 32 says: "If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability."

*Revenue Recognition When a Third Party Assumes the Entity's Obligation to Supply Awards to the Customer*

As indicated above, the AASB agrees with the proposal in paragraphs 8(b) and 9 of D20 that revenue should be recognised when a third party assumes the entity's obligations to supply awards to the customer. However, the AASB considers this should only occur if the assumption is on a non-recourse basis. This is because, consistent with accounting for award credits under paragraph 13 of IAS 18, the extinguishment of the entity's obligation to supply awards gives rise to revenue. Under a non-recourse assumption[1], the entity's legal obligation is extinguished in return for the consideration paid by the entity for the assumption, and thus revenue arises. However, under an assumption in which the customer continues to have recourse to the entity, the entity purchases a right to the third party's promise to provide the awards (an asset) but its obligation is not extinguished. Therefore, revenue should not be recognised when the latter form of assumption occurs.

The AASB observes that the last sentence of paragraph BC13 of the Basis for Conclusions supports its recommendation. That sentence is: "However, if the entity has *no obligations* in respect of the delivery of the awards, it should not defer revenue." (emphasis added)

*Retrospective Application*

The AASB disagrees with requiring the Interpretation to be applied retrospectively, as proposed in paragraph 12 of D20. If an entity has previously accounted for award credits as an expense at the time of the "initial sale", measured by reference to the estimated cost of supplying the goods or services, it might not possess the information needed to retrospectively allocate the customer consideration for now-completed "initial sales" to those award credits. In other words, the entity will have been measuring the exit values of its award credits (which could have been performed in aggregate for similar types of

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[1] This term has the same meaning as a *legal assumption*, as referred to in the IASB-FASB Revenue Recognition project, but the AASB prefers it because it is more self-explanatory.

awards) but would now be required to identify the entry values of all unredeemed award credits, separately for each "initial sale". Therefore, the AASB suggests that the Interpretation should be applied prospectively from its effective date.

*Proposed Clarifications and Other Proposed Editorial Amendments*

*Measurement of award credits*

Paragraphs BC8 and BC9 of the Basis for Conclusions say the amount of revenue attributed to award credits should be the fair value of the consideration received (or receivable[2]) for them, and that when this amount is not directly observable, it should be determined using a relative fair value allocation. The AASB agrees with these principles, but notes that the draft Consensus does not say quite the same thing.

The first mention of the measurement basis in the draft Consensus (the second sentence of paragraph 5) refers to an allocation of fair value, which paragraph 6 says shall be made by reference to the relative fair values of the components.

The AASB recommends that the Consensus be conformed to the abovementioned wording in the Basis for Conclusions. It is inappropriate for paragraph 6 of the draft Consensus to equate the relative fair values of the components of an "initial sale" with the amounts for which each component could be sold separately. Those latter amounts are the fair values[3] of the components, which are used to determine their relative fair values.

Paragraph BC10 of the Basis for Conclusions includes guidance on how the fair value of award credits may be measured. The AASB recommends including it in the Consensus.

*Timing of revenue recognition from extinguishing award credits*

The AASB considers that paragraph 8 should refer to recognising revenue when obligations for award credits are extinguished, rather than when award credits are redeemed. Accordingly, paragraph 8(a) of the Consensus should also mention that revenue is recognised when award credits expire. At present, paragraph 8 only covers expirations implicitly in the reference at its end to "the total number expected to be redeemed".

The use of "either" in paragraph 8 of the draft Consensus does not cater for circumstances in which revenue is recognised as award credits are redeemed (or expire) and then is recognised when the remainder of award credits is assumed by a third party. The AASB recommends rewording paragraph 8 to cater for these circumstances. One possible solution would be to refer in paragraph 8(b) to a third party assumption of the *remaining* obligation to supply awards (which would also work when the assumption occurs immediately after award credits are granted).

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2 These words in parentheses should be added in paragraph BC8 for consistency with IAS 18 and other parts of D20.

3 This characterisation is consistent with EITF Issue 00-21 *Revenue Arrangements with Multiple Deliverables*, paragraph 16, second sentence.

*Customer relationship intangible assets*

The AASB suggests deleting paragraph 11 of the draft Consensus, which says that customer relationship intangible assets created or enhanced by customer loyalty programmes are recognised if they meet the recognition criteria in IAS 38 *Intangible Assets*. Paragraph 11 adds nothing to the guidance provided by IAS 38. The AASB considers that it is unhelpful to touch briefly on this issue without discussing the concerns of some constituents that, because the restrictive recognition criteria in IAS 38 would preclude recognition of many customer relationship intangible assets although award credits would be recognised as liabilities under IAS 18, financial statements may fail to provide a fair presentation of the overall financial effect of customer loyalty programmes. Nevertheless, the AASB does not disagree with the accounting treatment mentioned in paragraph 11 of D20.

The AASB disagrees with using the phrase "recognised only if" in paragraph 11 of D20, if that paragraph is retained. It is biased because it emphasises the prohibition of recognising such assets if they fail to meet the recognition criteria in IAS 38, but could be interpreted to imply that an entity may elect not to recognise such assets when they *do* meet the recognition criteria in IAS 38. The AASB recommends that, if paragraph 11 is retained, the abovementioned phrase be amended to "recognised if, and only if,", consistent with paragraph 21 of IAS 38.

If you have queries regarding any matters in this submission, please contact Jim Paul (jpaul@aasb.com.au) or myself.

Yours sincerely

David Boymal

David Boymal
Chairman