KPMG

Financial Reporting Matters

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AUDIT

The IFRIC has issued a proposed interpretation on the accounting for customer loyalty programmes. What is its impact on businesses such as credit card providers, airlines and petrol stations that have these programmes? In this issue, we also highlight an upcoming interpretation on interim financial reporting and impairment.

The International Financial Reporting Interpretation Committee (IFRIC) has issued a draft interpretation D20 *Customer Loyalty Programmes*. The draft interpretation addresses the accounting by entities that operate, or participate in customer loyalty programmes for their customers.

Many businesses today such as credit card providers, airlines and petrol stations have customer loyalty programmes. Each time a customer buys a good or service, the entity grants loyalty points to the customer. The customer can then redeem these points for free or discounted goods, or services.

The issue that arises is whether the entity that grants the loyalty points should account for these points:

- as a separately identifiable component; or
- by recognising all revenue immediately and recognising a provision for any incremental costs of fulfilling the obligation arising from the customer loyalty programme.

The IFRIC has also issued IFRIC Interpretation 10 *Interim Financial Reporting and Impairment* (IFRIC 10). This interpretation states that an entity should not reverse an impairment loss recognised in a previous interim period, when these losses are pertaining to goodwill, investment in an equity instrument or financial assets carried at cost.

As of 6 October 2006, the Council on Corporate Disclosure and Governance (CCDG) has not yet issued the equivalent of IFRIC 10. As this interpretation is likely to be issued, let us discuss the impact of this interpretation on companies in Singapore that announce interim financial results.

Contents

A. Proposed interpretation on accounting for customer loyalty programmes

How are loyalty points currently accounted for?

When an entity grants loyalty points to its customers in connection with the sale of goods or services, the sale may be regarded as having two separate components. These are:

- the goods delivered or the services rendered at the time of sale; and
- the loyalty points awarded.

Due to a lack of guidance under the existing IFRS, there are currently different ways of accounting for these loyalty points.

The two methods commonly used by entities are the:

- *Deferral* method: **A portion of the revenue is deferred because some of the service has not yet been provided.** The amount deferred is recognised in revenue only when the loyalty points are redeemed, and the further goods or services are provided. The rationale is that the loyalty points awarded are separately identifiable from the other goods or services sold as part of the initial sale. Thus, the customers are also paying for the loyalty points (albeit implicitly) that could be used to redeem future free or discounted goods, or services. As such, the entity should only recognise the portion of revenue relating to the goods or services provided, and defer the portion of revenue relating to the loyalty points awarded at the point of sale.

- *Incremental* method: **The revenue from the sale is recognised based on the stated price of the goods sold, or services provided.** A provision is also recognised for the incremental cost of fulfilling the loyalty programme. The rationale is that the obligation to provide free or discounted goods, or services under the loyalty programme is often insignificant in comparison with the value of the purchases required to earn them. Therefore, this obligation is not considered to be a significant part of the sales transaction. An entity should therefore recognise revenue from the sale of goods or provision of services when it has transferred significant risks and rewards of ownership to the customer. Any costs to be incurred would be recognised at the same time as the revenue. This is similar to the case where an entity provides warranty on items such as cars or air-conditioners that have been delivered to the customer.

What is the proposed treatment in the draft interpretation?

In view of the diverse treatments, the IFRIC decided to provide guidance on the accounting for loyalty points. As such, the IFRIC issued a draft interpretation D20 *Customer Loyalty Programmes* in September 2006. The period for comment ends on 6 November 2006.

The proposed consensus in the interpretation is to apply the deferral method to account for the loyalty points. This means recognising the points awarded as a separately identifiable component of revenue, and deferring the recognition of revenue until the loyalty points are redeemed. The IFRIC's view is that the loyalty points are not a cost that directly relate to the goods and services already delivered. Instead, the loyalty points are separate goods or services to be delivered at a later date.

How to allocate the consideration received?

The relative fair value method should be applied at the point of initial sale. The consideration received is allocated between the cost of the item sold or services rendered, and the loyalty points awarded.

In most cases, the fair value of the loyalty points would not be directly observable. The entity would therefore have to estimate the fair value of the loyalty points using an appropriate allocation method.

The draft interpretation suggests estimating the fair value of the loyalty points awarded by reference to the discount that the customer would obtain when redeeming the loyalty points for goods or services. If customers can choose from a range of different awards, the fair value of the loyalty points should reflect the fair values of the range of available discounts. This is weighted in proportion to the frequency at which each is expected to be selected.

Another method suggested is to estimate the fair value of the loyalty points by reference to the amount the entity would pay to a third party to fulfill the obligation of the loyalty programme.

Although the draft interpretation includes guidance on how the fair value of the loyalty points could be estimated, it does not insist on any specific technique. Other estimation techniques may be used so long as the amount provided is a reasonable estimate of the fair value of the loyalty points.

When does the entity recognise revenue from the loyalty points?

The revenue from the loyalty points can be recognised either:

- in the periods when the loyalty points are typically redeemed; or
- when a third party assumes the obligation to supply the free (or discounted) goods or services to the customers.

What happens if actual redemption is higher than the expected redemption?

In such an instance, the entity recognises an additional liability to satisfy its obligation to supply free (or discounted) goods or services. The increased liability is recognised in the profit and loss account as an expense in the current period. The change in expectation does not affect the consideration received, or revenue recognised from the initial sale.

B. Interim financial reporting and impairment

What is the issue?

The current IAS 36 *Impairment of Assets* and IAS 39 *Financial Instruments: Recognition and Measurement* prohibits an impairment loss arising from the following items to be reversed in subsequent periods:

- goodwill;
- investment in equity instruments classified as available-for-sale financial assets (AFS equity instruments); and
- financial assets carried at cost. For example, an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured.

Assume Entity A recognises an impairment loss in the first quarter for financial year (FY) 2007 ending 31 December 2007 in respect of its AFS equity instruments. If Entity A had made the impairment assessment at the end of FY 2007 and not in the first quarter, it may not recognise any impairment loss or a smaller loss may have been recognised.

Based on IAS 34 *Interim Financial Reporting*, the frequency of an entity's reporting should not affect the measurement of its annual results. Therefore, in the situation above, it would seem that Entity A would be allowed to reverse the impairment loss recognised in the first quarter of FY 2007 when it prepares its annual financial statements for the FY ending 31 December 2007.

This conflict with IAS 36 and IAS 39 which specifically prohibits the reversal of impairment losses pertaining to goodwill, an AFS equity instrument or a financial asset carried at cost.

As such, an issue arises as to whether the requirements in IAS 36 and IAS 39 should take precedence over the requirement in IAS 34.

What is the consensus in IFRIC 10?

The IFRIC has issued IFRIC Interpretation 10 *Interim Financial Reporting and Impairment* (IFRIC 10) to address this dilemma.

The IFRIC concluded that the prohibition in IAS 36 and IAS 39 on the reversal of impairment loss recognised on

- goodwill,
- an AFS equity instrument, or
- a financial asset carried at cost

should take precedence over the more general statement in IAS 34 regarding the frequency of an entity's reporting not affecting the measurement of its annual results.

An entity is therefore not allowed to reverse an impairment loss recognised in a previous interim period.

What is the effective date of this interpretation?

An entity should apply IFRIC 10 prospectively from the date it first applied IAS 36 or IAS 39. IFRIC 10 is effective for annual periods beginning on or after 1 November 2006. Its application for earlier time periods is encouraged.

> Entity A first applied IAS 39 in the financial year ended 31 December 2005. In the second quarter of FY 2005, it recognised an impairment loss of $500,000 relating to its AFS equity securities measured at fair value.
>
> However, this impairment loss was reversed when Entity A prepared the annual financial statements for FY 2005 on the basis that the impairment was not required as at 31 December 2005, as conditions had improved for the period from second quarter of FY 2005 to end of FY 2005.
>
> If Entity A applies IFRIC 10 for financial year ending 31 December 2006, Entity A has to restate the FY 2005 financial statements to recognise the impairment loss of $500,000. This would be accounted for as a change in accounting policy as a result of applying a new interpretation.
>
> If Entity A applies IFRIC 10 for financial year ending 31 December 2007, Entity A has to adjust the opening retained earnings at 1 January 2006 by $500,000 as a result of applying the new interpretation.

Can I extend the conclusion in IFRIC 10 to other areas of potential conflict between IAS 34 and other standards?

No, the consensus in IFRIC 10 is only applicable for this specific issue. The IFRIC has specifically stated in the interpretation that the consensus in IFRIC 10 cannot be extended to other areas of potential conflict between IAS 34 and other standards.

C. Developments in international standards and interpretations

IASB's Projects Overview

Refer to IFRS Briefing Sheet Issue 55 for details

This Briefing Sheet summarises the status of current projects of the International Accounting Standards Board (IASB), and reflects the significant discussions of the IASB.

The amendments to IFRS 3 *Business Combinations*, IAS 27 *Consolidated and Separate Financial Statements* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in relation to the Business Combinations phase II project are expected to be issued in the second half of 2007.

Draft Interpretation D19 *IAS 19 – The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements*

Refer to IFRS Briefing Sheet Issue 54 for details

This draft interpretation clarifies when economic benefits in the form of a refund or reductions in future contributions to the plan may be considered "available". It also provides guidance on the effect of minimum funding requirements on the measurement of the defined benefit asset or liability.

The CCDG has issued an identical exposure draft in Singapore on 1 September 2006, with comments due by 30 September 2006.

IASB July 2006 Meeting

Refer to IFRS in Brief Issue 27 for details

At its July 2006 meetings, the IASB

- reaffirmed that liabilities for restructuring costs should be recognised as part of the cost of a business combination, only if these costs meet the recognition criteria for liability under IAS 37;
- reaffirmed that the vesting conditions in IFRS 2 *Share-based Payment* are restricted to performance or service conditions only, and that cancellations by parties other than the entity be accounted for in the same way as cancellations by the entity.

The KPMG International publications covered in this issue are:

- IFRS in Brief: issue 27
- IFRS Briefing Sheet: issues 53 to 56

This section provides a highlight, particularly the relevance of international developments in the local context, of our international publication – *IFRS in Brief* and *IFRS Briefing Sheet*. You can access the electronic version as follows:

IFRS in Brief:
http://www.kpmg.com.sg/newsletters/ifrs_in_brief.html

IFRS Briefing Sheet:
http://www.kpmg.com.sg/newsletters/ifrs_briefing_sht.html

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