Industry views
Telecommunications Industry Accounting Group

Making sense of a complex world*

IFRIC 13 – Customer loyalty programmes

Introduction

The issuance by the International Financial Reporting Interpretations Committee (IFRIC) of IFRIC 13, Customer Loyalty Programmes, has implications for telecom operators. This publication considers the accounting and the practical implications that arise from the guidance in IFRIC 13.

Telecom companies operate in a highly competitive environment. For many operators, the focus has moved from acquiring new customers to maintaining market share and encouraging the customer base to increase usage. One manifestation of this change in emphasis is the proliferation of customer incentive and customer loyalty programmes.

The accounting practice for customer loyalty arrangements in the telecoms sector has been varied. IFRIC 13 was issued to bring consistency and comparability to accounting for loyalty programmes across industry sectors. While understanding the technical provisions of the interpretation is important, it is only half the battle. As operators prepare to apply IFRIC 13 in upcoming interim and annual financial statements, the practical implications in terms of data gathering and changes to systems and processes are becoming apparent.

We trust that you will find this publication useful as you look to apply IFRIC 13 for the first time.

Paul Barkus

Chairman
PwC Telecom Industry Accounting Group

Why was IFRIC 13 issued?

Customer loyalty programmes are widespread. Telecom operators, retailers, airlines, hotels and similar businesses offer many incentives to their customers. The incentives offered through loyalty programmes often take the form of a "points" scheme, in which customers earn points for purchasing goods or services. The customers can redeem the points for free or discounted goods and services.

This publication explores the accounting for award credits, or points, under IFRIC 13 Customer Loyalty Programmes (IFRIC 13).

How will IFRIC 13 affect telecom operators?

Most telcos operate in a highly competitive environment and invest significantly in acquiring and retaining customers. Their incentive arrangements typically include:

- Free gifts (such as MP3 players or digital cameras) on signing or renewing a contract for service.
- Arrangements in which customers can earn the right to a discount on equipment (handsets, modems and other devices) or service on the condition that they renew their service contract.
- Awards that entitle customers to discounted goods and services from their telecom service provider.
- More complex arrangements that include points that entitle the holder to discounted goods or services provided by another company (for example, the ability to earn air miles).

In our view, there are two key areas of consideration for telecom operators:

1. Which customer incentive arrangements are within the scope of IFRIC 13?
2. If the arrangement is within the scope, how can the fair value of the incentive be determined?

Before examining these two specific areas, we have summarised, below, the principal requirements of IFRIC 13.

Background

Historically, the accounting for loyalty programmes has been varied, and many companies have treated the cost of redeeming award credits or points as a marketing expense.

So, what exactly is a loyalty programme?

According to IFRIC 13, a customer loyalty programme has the following characteristics:

- Entities use loyalty programmes to incentivise customers to buy additional goods or services.
- Entities grant credits (in the form of points) to customers with each purchase of goods or services.
- Customers may redeem the points to receive free or discounted goods or services in the future.
- The programmes can operate in a variety of ways:
  - Customers must collect a minimum number or value of points before redeeming them.
  - Customers may earn points on a single purchase or on contract renewal over a specified period.
  - Either the entity or a third party may run the programme.

As noted above, historically the accounting for loyalty points has been varied. But IFRIC 13 treats points as something sold in their own right as part of a multiple element arrangement. Although not part of the interpretation itself, the IFRIC also clarified that points are distinct from marketing expenses because they are granted to a customer as part of a sales transaction. Marketing expenses, in contrast, are incurred independently of the sales transactions they are designed to secure.

The following table summarises the expected impact of IFRIC 13 on common current practice.

	Current practice	IFRIC 13
Income statement classification	Allocation of revenue to separable elements or charge to marketing expense	Allocation of revenue to separable elements
Balance sheet classification	Accrual/provision	Deferred revenue for amounts allocated to points
Measurement	Various, but generally at related cost to fulfil the obligation for the company	Fair value to the customer
Point of recognition of the awards in the income statement	Various: at grant or at redemption	At redemption

Background (continued)

IFRIC 13 clarifies that loyalty programmes are multiple element arrangements, in which the consideration received for the sale of goods or services (from which points are earned) is allocated between:

1. The goods or services delivered; and
2. The points that will be redeemed in the future.

The consideration should be allocated to the goods or services initially provided and to the points, based on their fair value. Fair value is defined as the amount that the points could be sold for on a stand-alone basis. The consideration allocated to the points should be presented as deferred revenue on the balance sheet and should be released to the income statement when the points are redeemed or expire.

The following simple example illustrates the basic principles of IFRIC 13.

Example 1

An operator launches a loyalty programme under which it grants points to customers in exchange for purchasing airtime. The points may be redeemed for a discount on the price of a handset upon renewing a contract. Customers who earn 100 points will be entitled to a discount of €50 off the handset.

A customer uses services throughout the initial 12-month contract term, paying €20 per month for airtime (a total of €240 over the contract term) and earning 100 points. The operator has assessed that the customer will redeem the points.

Throughout the year, the operator should record a total of €50 as deferred revenue, thus recognising €190 (€240 - €50) as airtime revenue. The €50 of deferred revenue represents the fair value of the points to the customer.

When the customer redeems the points, the €50 of deferred revenue will be released and recognised as revenue. Hence, overall the total revenue always will be €240 (€190 + €50). However, because the customer has been granted points that s/he is expected to redeem, some of the total revenue (€50) is allocated to the points (based on fair value) and is deferred until the points are redeemed or expire.

Note: The basis of determining fair value has not been considered in this example (see example 2 for further discussion).

Understanding the scope of IFRIC 13

A customer incentive arrangement is included within the scope of IFRIC 13 if both of the following conditions are met:

- The entity grants points to its customers as **part of a sales transaction** - that is a sale of goods or a rendering of services; and
- Subject to meeting any further qualifying conditions, the customers can **redeem the points in the future** for free or discounted goods or services.

It follows that IFRIC 13 does not apply where there is no link to a sales transaction. An example is a voucher for a price reduction on a handset included in a newspaper promotion.

Many markets are characterised by operators giving incentives and discounts at the outset of a relationship with a customer. Examples include free gifts, for example DVD or MP3 players and, in some markets, domestic appliances. We do not believe that these types of arrangements fall within the scope of IFRIC 13. The customer is given the gift at the outset, and there are no further qualifying conditions or points granted that the customer could redeem in the future. We have considered the accounting for free gifts and handsets in our publication *Accounting for handsets and subscriber acquisition costs*[1].

In more mature markets, it is increasingly popular for operators to give customers the right to a free or discounted handset on the renewal of their service contract. These rights are granted to customers when they sign their first service contract.

Earlier we considered the example of customers earning points that they could redeem against a handset on renewal of their contract. It is common that, by the time customers are ready to renew their contract, the options available to new customers are at least as advantageous, if not better, and existing customers will be able to participate in the new customer schemes. While these arrangements are within the scope of IFRIC 13, careful consideration needs to be given to questions of the value of the discount or the incentive to customers as well as the likelihood that customers will redeem the points.

1 Making Sense of a Complex World: Accounting for Handsets and Subscriber Acquisition Costs. PricewaterhouseCoopers, August 2008

What is fair value?

Consideration received or receivable from customers is allocated to the various elements of the arrangement using fair values. This might be estimated using just the fair value of the points or the relative fair values of the points and the goods or services sold. IFRIC 13 allows management's judgement and does not mandate a specific approach for estimating a point's fair value.

The guidance also recognises that there may not be an observable market for the incentive and hence an estimate will be required. The fair value of a point is expected to be based on:

- The discount that the customer will receive, that is, "the amount the customer will save"; and
- The expected redemption rate of the points.

The application of the guidance is considered in the example below.

Example 2

Year 1

- An operator launches a loyalty programme in which points are granted for using services or buying equipment.
- The points entitle the holder to a discount on the retail price of a handset or an airtime credit. For example, a customer who has accumulated 100 points may purchase for the reduced price of €50 a mobile phone that retails for €150 (that is, one point has a face value of €1).
- The operator expects half of the points granted to be redeemed (that is, a redemption rate of 50%).
- At the end of the first period after launching the programme:
  - Customers have accumulated a total of 200,000 points.
  - The total consideration from customers amounts to €1,000,000.

Initial allocation of revenue

- The total consideration should be allocated to both elements of the arrangement, that is, the initial sales transaction and the points earned by the customers. The allocation should be based on fair value.
- As noted above, the face value of each point is €1. That is the amount a customer will save through redeeming each point.
- The fair value of the points is calculated as follows:
  200,000 points x €1 (face value) x 50% (redemption rate) = €100,000.
  Therefore, the fair value of the points accumulated by customers in year 1 is €100,000. That amount should be recorded as deferred revenue.
- The remaining consideration of €900,000 (€1,000,000 - €100,000) should be recorded as service revenue in accordance with the operator's normal accounting policies.

Accounting at end of initial period			
Dr	€	Cr	€
Cash	1,000,000	Service revenue	900.000
		Deferred revenue	100,000
Total	1,000,000		1,000,000

What is fair value? (continued)

Year 2

- The operator continues the scheme in year two. A further 160,000 points are granted.
- Consideration received from customers amounts to €800,000.
- The scheme remains the same, that is, the face value of a point is still €1.
- Of the points granted in year 1, 120,000 are redeemed during the year, and the operator changed its views about redemption rates, assuming that 75% of the points will be redeemed.

Subsequent accounting (year 2)

Accounting for the new points issued in year 2

- The face value of the points continues to be €1.
- The fair value of the points awarded in year 2 is €120,000 calculated as follows: 160,000 points x €1 (face value) x 75% (redemption rate).
- Hence, revenue of €120,000 should be deferred at the end of year 2 in respect of the new points granted, and service revenue of €680,000 should be recorded in the year (€800,000 - €120,000).

Accounting for year 1 points still outstanding

- The operator has reassessed the redemption rate from 50% to 75%. This means that the operator expects 150,000 of the points issued in year 1 to be redeemed (200,000 points issued in year 1 x 75%).
- By the end of year 2, 120,000 of the points have been redeemed. Revenue should be recognised in respect of the year 1 points redeemed in proportion to the expected levels of redemption, as shown below:
  - Proportion of points redeemed: 120,000/150,000 = 80%
  - Revenue deferred in year 1: €100,000
  - Revenue to be recognised in year 2: €80,000 (€100,000 x 80%)

Accounting for new points at the end of year 2

Dr	€	Cr	€
Year 2 points			
Cash	800,000	Service revenue	680.000
		Deferred revenue	120,000
Total	800,000		800,000

Accounting for year 1 points outstanding at the end of year 2

Dr	€	Cr	€
Year 1 points			
		Balance b/fwd	*100,000*
Deferred revenue	80,000	Service revenue	80.000
		Balance c/fwd	*20,000*

What is fair value? (continued)

Fair value is the amount the customer will save by redeeming the points. The face value of a point is not necessarily its fair value. It is also necessary to take into account the redemption rate assumed in respect of the points.

While the redemption rate should be revisited each balance sheet date, as illustrated in Example 2, the amount of revenue deferred in respect of the points is not remeasured. The rate of recognition of the deferred revenue is adjusted for any changes in redemption rates.

Principal or agent?

IFRIC 13 requires an entity issuing points to determine whether it is collecting revenue on its own account (as principal in the transaction) or on behalf of a third party (as an agent). When the entity is collecting revenue on behalf of a third party, it earns commission income:

- Commission income is the net amount - the difference between the consideration allocated to the points and the amount payable to the third party supplying the points.
- Commission income should be deferred until the third party is obliged to supply the awards and is entitled to receive consideration for doing so.

When the issuing entity is acting as principal and is collecting consideration on its own behalf, then revenue should be measured as the gross consideration. An element of the revenue, however, clearly will need to be deferred until the points are redeemed or expire.

Example 3

An operator has a loyalty programme arrangement with an airline company called Miles & More. For every €1 that is billed to a customer for mobile services, the customer is awarded one mile.

The awarded miles can be redeemed for air tickets under the airline's scheme.

The benefits to the operator are that:

- There is no need to administer the scheme.
- The operator does not have an obligation in respect of outstanding points.

The face value of each point is €0.10, and for each point issued, the operator will pay €0.09 to the airline. In doing so, the operator will earn €0.01 of commission income. Once the operator has made payment to the airline, it has no further obligation to the customer.

The accounting for this arrangement would be as follows:

When the operator makes a sale of €10, it issues points with the face value of €1:

Dr Cash	€10.00
Cr Revenue	€9.00
Cr Commission income	€0.10
Cr Liability to airline	€0.90

The operator will need to consider whether the commission income should be recorded as revenue or as other operating income.

Revenue or other income?

The points might be redeemed against goods or services not supplied in the normal course of business. There are two aspects to consider:

1. Typically a company would not buy or trade goods that are not used in its ordinary course of business, so a third party is likely to be involved. Hence, it will be necessary to determine whether the operator is acting as agent or as principal.
2. When no third party is involved, the guidance in IAS 18 should be applied to determine whether the income statement credit is to revenue or to other income. The standard defines revenue in the context of "the ordinary activities of the entity". Determining the ordinary activities, and therefore distinguishing revenue from other income, is not always clear. Indeed, an item could be revenue for one operator but other income for another in the same market. The facts and circumstances of the business and the transaction should be considered on a case-by-case basis.

What data does the company need to collect?

Operators that issue points will need to collect sufficient information to enable them to estimate the individual fair value of the points, expected level of redemptions, actual redemptions and cancellations/lapses.

The following list illustrates how individual fair value should be determined.

Type of incentive	Indicative individual fair values
Money-off coupon or voucher attached to a product	Cash value of coupon or voucher
Points earned as goods or services are purchased	Based on the value of the goods or services the points can buy or on the price at which they can be sold
Points earned from the operator that can be used in other stores	Based on the value of the goods or services the points can buy

Historical information often will provide the best evidence to support an estimate of the redemption rate. However, the assumptions used in highly complex arrangements may need to be discussed with a valuation specialist.

What happens when an incentive could result in a loss on future sales?

As noted previously, free gifts are not within the scope of IFRIC 13. However, the unlikely situation could occur that a point (within the scope of IFRIC 13) is issued that results in a loss on the sale of the later item. The point arrangement then would be accounted for as an onerous contract, and provision would be made in accordance with *IAS 37 Provisions, Contingent Assets and Contingent Liabilities*.

Discount vouchers issued separately from a sales transaction (and therefore outside IFRIC 13's scope) are deducted from revenue when a sale is made and the discount voucher is redeemed. There are no accounting entries in advance of the sales transaction, unless redemption of the vouchers will result in products (or services) being sold at a loss. In these circumstances, the seller has created an onerous contract, and provision should be made in accordance with IAS 37.

The date for applying IFRIC 13

The interpretation is to be applied to financial periods beginning on or after 1 July 2008. Consequently, calendar year reporters will be required to adopt the interpretation in financial statements for the year ending 31 December 2009. Operators should remember that interim financial statements and the comparatives should reflect IFRIC 13. There are no special transitional provisions, so any change in accounting policy should be accounted for in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Hence, operators will need to consider the position at both the beginning and the end of the comparative period.

Brief comparison to US GAAP

The US Financial Accounting Standards Board's Emerging Issues Task Force (EITF) was unsuccessful in developing a model to account for these point and loyalty programmes in its deliberations of EITF 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*.

Of the five issues discussed by the task force, Issue 3 (how a vendor should account for an offer to a customer to rebate or refund a specified amount of cash that is redeemable only if the customer completes a specified cumulative level of revenue transactions or remains a customer for a specified period of time) was the only issue on which a consensus was reached. It was later codified in EITF 01-9 *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*.

Due to the lack of consensus in EITF 00-22, there remains a divergence in practice in the US for the accounting for loyalty programmes. It is acceptable for operators to account for loyalty programmes as multiple element arrangements using an analogy to EITF 00-21 *Revenue Arrangements with Multiple Deliverables*, or to IFRIC 13. In certain circumstances, when the costs of fulfilling the points are inconsequential or perfunctory, the incremental cost model may be appropriate under US GAAP. But using this approach will not be acceptable under IFRS once IFRIC 13 is adopted. Operators should use the appropriate US GAAP literature (for example, EITF 01-9) for other types of incentive programmes.

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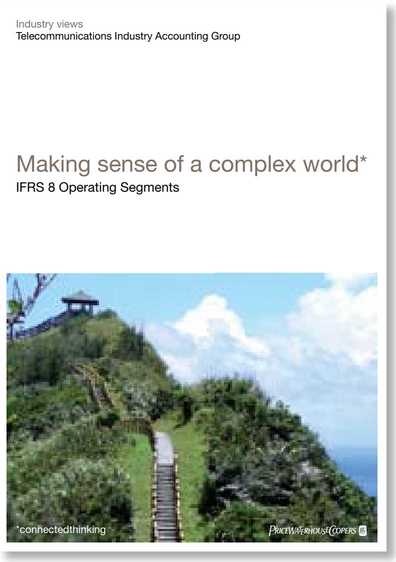

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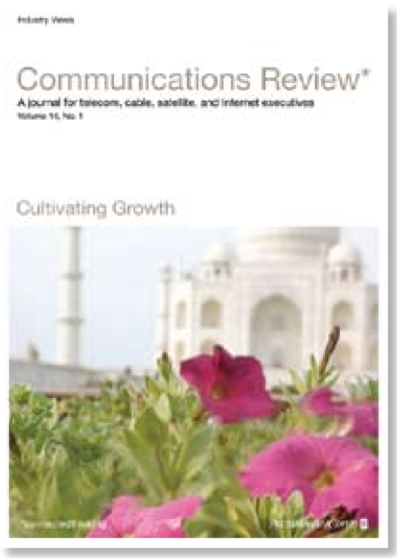

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Contacts

PricewaterhouseCoopers has dedicated IFRS specialism in most territories. Should you wish to talk to a specialist in your country, please contact a member of the team who will be able to put you in touch with the most relevant person.

Americas

John Horan
San Jose
john.horan@us.pwc.com
+1 408 817 3809

Pierre-Alain Sur
Little Rock
pierre-alain.sur@us.pwc.com
+1 501 907 8085

Richard Veysey
New York
richard.veysey@us.pwc.com
+1 646 471 7973

EMEA

Paul Barkus
London
paul.barkus@uk.pwc.com
+44 20 7213 5514

Fiona Dolan
London
fiona.mc.dolan@uk.pwc.com
+44 20 7213 4885

Katharine Finn
London
katharine.finn@uk.pwc.com
+44 20 7213 4105

Peter Hogarth
London
peter.hogarth@uk.pwc.com
+44 20 7213 1654

Fernand Izeboud
Amsterdam
fernand.izeboud@nl.pwc.com
+31 20 568 4226

Rich Sharko
Moscow
rich.sharko@ru.pwc.com
+7 495 9676054

Thomas Tandetzki
Düsseldorf
thomas.tandetzki@de.pwc.com
+49 211 981 1105

Asia Pacific

Laura Butler
Beijing
laura.butler@cn.pwc.com
+86 10 6533 2363

Matthieu Moussy
Tokyo
matthieu.moussy@jp.pwc.com
+81 80 3520 5216

Sean Tuckfield
Hong Kong
sean.tuckfield@hk.pwc.com
+852 2289 2368

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