IFRIC13 Revolutionized Loyalty Programs. What will the new IFRS 15 and US ASC 606 rules mean for your program?

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Background

- May 2014: US FASB and IASB issue converged standard on revenue recognition
- **Goal:** Promote better understanding and comparability across companies for financial report users
- **Key concept:** Better alignment of revenue recognition with the satisfaction of performance obligations
  - Points from loyalty programs are now separate obligations
- **Potential impact**
  - Change in revenue deferral
  - Change in balance sheets liabilities
  - Additional disclosures in financial statements
Effective date and transition

- Under U.S. GAAP, public companies and non-public entities will start applying the new revenue recognition rules in 2018 and 2019, respectively.
  - U.S. GAAP reporters are permitted to early adopt up to one year early.
- The revenue standard is effective for entities that report under IFRS beginning in 2018.
  - IFRS has permitted early adoption from the date that the standard was issued.
- The Boards also allowed two alternative methods for the initial reporting under the revenue standard:
  - Full retrospective method
  - Modified retrospective method
## IFRS 15 standard versus IFRIC 13

<table>
<thead>
<tr>
<th>New model (IFRS 15)</th>
<th>Current IFRS (IFRIC 13)</th>
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<tbody>
<tr>
<td>Loyalty points are an option to acquire additional goods/services creating a <strong>separate performance obligation</strong> to the issuer.</td>
<td>Loyalty programs are accounted for as multiple-element arrangements. Some revenue is <strong>deferred</strong> and recognized when the awards are redeemed or expire.</td>
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<tr>
<td>Management to estimate the transaction price to be allocated to the separate performance obligations.</td>
<td>Revenue is allocated between the good or service sold and the award credits, taking into consideration the <strong>fair value of the award credits</strong> to the customer.</td>
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<tr>
<td>The transaction price is allocated between the product and the loyalty reward performance obligations based on a <strong>relative standalone selling price</strong>.</td>
<td>Deferred revenue related to points breakage is recognized as revenue is recognized for redeemed points.</td>
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<tr>
<td>The entity recognizes revenue for the option when those future goods or services are transferred to the customer or when the option expires.</td>
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### Potential impact

- The new revenue standard is consistent with the deferred revenue or multiple-element model currently required under IFRS.

- Main change is the introduction of the **relative standalone selling price** concept.
Allocation of consideration under IFRS

- Consider a sale of a flight for $100 which comes with loyalty points worth $5 (using fair value)

- IFRIC 13 → Most entities apply the **residual method** and **defer $5**

- IFRS 15 → Residual method is generally prohibited – Revenue is allocated based on **relative stand-alone selling price** as follows:

  $$\$100 \times \left[ \frac{\$5}{\$100 + \$5} \right] = \$4.76$$  deferral

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**Lower deferral under IFRS 15**
ASC 606 standard versus US GAAP

- New model under ASC 606 is the same as under IFRS 15

Current US GAAP

- Multiple approach are accepted under U.S. GAAP in the accounting for loyalty programs: two models commonly followed are an incremental cost accrual model and a deferred revenue model.

- Under the incremental cost model, revenue is typically recognized at the time of the initial sale and an accrual is made for the expected costs of satisfying the awards credits (at internal company cost).

- The deferred revenue model under US GAAP is similar to ASC 606.

Potential impact

- We expect minimal impact for US GAAP preparers currently using the deferred revenue model.

- The incremental cost model is more prevalent in practice across US (except for most US airlines). This will generally result in 1) higher cost (fair value versus internal cost) and 2) less upfront revenue as revenue related to points obligation is deferred.
Allocation of consideration under US GAAP - Incremental Cost

- Consider same sale of a flight for $100 which comes with loyalty points worth $5 (using fair value) but internal cost of points is $1 to program

- Current US GAAP → Program recognizes $100 of revenue at point of sale and carries a $1 liability that gets released when points are redeemed or expire

- ASC 606 → Revenue is allocated based on relative stand-alone selling prices as follows:

\[
\$100 \times \left[ \frac{\$5}{\$100 + \$5} \right] = \$4.76 \text{ deferral}
\]

Much higher liability under ASC 606 for US companies currently using the incremental method

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Keys issues for program managers

As the new standards get implemented, program managers can expect:

- Increased scrutiny from C-Suite and finance department as deferred revenue amounts change
- The true value and underlying metrics of the program will not change...but this might need to be better articulated to management
- If more revenue gets deferred, management might push to accelerate revenue recognition through faster point redemptions, for example:
  - New redemption options
  - Quicker expiration of points

The implementation of the new standards will generate in depth conversations between your companies’ program management and finance teams, creating significant opportunities for collaboration.
New disclosures

The new revenue recognition standard requires additional qualitative and quantitative information about loyalty programs regarding its contracts with customers and significant judgments and changes in judgments.

Examples of new disclosures:

- Detailed information as to how the loyalty points liability has moved during the year
- Information about how much revenue recognized in a period was included within deferred income at the previous year end, and the amount of current year revenue that relates to performance obligations satisfied in previous years
- An estimate of the timing of satisfaction of the loyalty points liability
- Information about the methods, inputs and assumptions used for estimating the stand alone selling price of performance obligations
Areas companies are focusing on

Companies around the world are investing significant accounting efforts and resources due to the new standard in the following areas:

- Identification of accounting changes
- Differences in the accounting at a consolidated level compared to the stand-alone books of the loyalty program
- Application of the breakage guidance and selection of an accounting model
- Agent / principal considerations around redemptions
- Drafting and review of accounting papers
- Calculating transition adjustments

This change in standard is complex and companies need to have a plan in place shortly as the effective date is coming up soon.
Our team

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