# CUSTOMER LOYALTY PROGRAMMES ACCOUNTING UNDER IFRS AND ROMANIAN ACCOUNTING SYSTEM

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***Abstract***

A customer loyalty programme is a marketing tactic employed by retailers to entice consumers, through rewards, into loyal buying behaviour and the provision of their purchasing preferences in order to increase profits. This tactic does not concern solely marketers, it is of interest to accountants as well. In preparation of IFRS financial statements, accountants need to understand this marketing operation in order to ensure compliance.

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## 1. Customer Loyalty Programmes – A Requirement of the New Economy

Organisations are now keener on the customer retention concept. The change is based on the attitude that investments in customer retention programmes are more efficient than spending funds on attraction of new customers. The costs incurred are not the only stimulus to encourage customer loyalty. Organisations are also interested in retaining current customers as they generate higher added value by increasing the market share, income, profit and by accelerating business development and improving the organisation's image. Loyal customers know the organisation well, they do not need to be given so

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much information, and they can be called partners of the organisation as they recommend products to their friends.

Rewarding customer loyalty programmes are now among principal customer retention tools. Initiated in the 1980s with the aim to develop and strengthen customer relationship, loyalty programmes are still popular and are actively implemented in the retail, tourism, financial services and other sectors.

The definition of the loyalty programme should comply with the following requirements (Daukševičiūtė I, Vilkaitė N, Valainis A., 2011):

• loyalty programmes should be considered as a component of the marketing strategy but not as the whole of the strategy;

• not only money or products of the organisation should be indicated as reward but also products or various discounts offered by other organisations;

• integrate aspects of both: the consumer’s positive attitude and behaviour favourable to the organisation;

• emphasise not only the effects of the loyalty programmes (or loyalty in general) but also the fundamental functions;

• take into consideration the reward provided by a loyalty programme to the organisation;

• focus not on the aspect of individualisation alone.

A customer loyalty programme is a marketing tactic employed by retailers to entice consumers, through rewards, into loyal buying behavior and the provision of their purchasing preferences in order to increase profits. The collection and analysis of this information, by assigning a unique identifier, such as a numerical ID or membership card to each programme member, is invaluable to retailers for numerous reasons. Some of these include (PR Loyalty Marketing Solutions, 2012): keep customers from defecting, prompt customers to make additional purchases, yield insight into customer behaviour and preferences, yield insight into the effectiveness of a business’s marketing efforts, facilitate business communication with customers, to enable a business to provide special, differentiated service to best customers, provide cross-branding recognition, collective advertising and cross-business promotions, attract new customers.

Loyalty programmes have various goals, most are related to the organisation’s goals. Daukševičiūtė I, Vilkaitė N, Valainis A., (2011) summarised the scientific literature and underlined the main goals for loyalty programmes: to offer added benefit to clients, to start and develop relations between the organisation and the client, to strengthen client loyalty, to retain current client base, to increase market share, to stimulate cross-sales, to increase profitability, to develop individualised products or packages, to stimulate repeated sales, to increase marketing efficiency, to increase sales income.

The typology of loyalty programmes provided by Daukševičiūtė I, Vilkaitė N, Valainis A., (2011) shows that loyalty programmes can be ***either accumulative or non-accumulative***. The customer may accumulate points, discounts or cash. The customers may exchange the accumulated points into products of the organisation or other organizations and/or discount for the product offered by the organisation and other organisations. Participants of loyalty programmes are rewarded with products of the organization or other organisations. In case of money rewards programmes the reward is cash. Customers who participate in a non-accumulative loyalty programme receive products of the organisation or other organisations.

## 2. Customer Loyalty Programmes under IFRS

The popularity of client loyalty programmes has increased drastically. In the absence of specific guidance on accounting for the obligation relating to the redemption of the award credits, differing practices have developed.

Either the cost of supplying the goods or service in the future was recognised as an expense at the time of selling the goods, giving rise to a liability, or the award credit was treated as a separate component of the sales transaction that required delivery in the future. Under both these approaches, differing practices were applied to factor the expected award redemption rates into the measurement of the liability.

On 1 July 2007 the International Accounting Standards Board (IASB) issued the Interpretation of International Financial Reporting Interpretation Committee (IFRIC) 13 to give specific guidance to suppliers on the accounting treatment of client loyalty programme transactions. This Interpretation has been applied by suppliers with annual periods beginning on or after 1 July 2008. The Interpretation addresses accounting by the entity that grants award credits to its customers (accumulative loyalty programmes).

IFRIC 13 applies to customer loyalty award credits that an entity grants to its customers as part of a sales transaction (i.e. a sale of goods, rendering of services or use by a customer of entity assets) and the customers can redeem in the future for free or discounted goods or services. The issues addressed in IFRIC 13 are:

(a) whether the entity's obligation to provide free or discounted goods or services ('awards') in the future should be recognised and measured by allocating some of the consideration received or receivable from the sales transaction to the award credits and deferring the recognition of revenue (applying paragraph 13 of IAS 18); or providing for the estimated future costs of applying the awards (applying paragraph 19 of IAS 18); and

(b) if consideration is allocated to the award credits: how much should be allocated to them; when revenue should be recognised; and if a third party supplies the awards, how revenue should be measured.

In essence, IFRIC 13 ***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.

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 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 be offered even to customers who have not earned award credits.

Factors influencing the quantification of deferred revenues (Vivek Raju P, 2011) are fair value, requirements for redemption, popularity of the programme, past experience of the organization.

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 2013 for bonus miles programme notes that "Fair value of the air miles is determined as the value for which miles could be sold separately, i.e. the average revenue, 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.

If the entity supplies the awards itself, it recognises the consideration allocated to award credits as revenue when award credits are redeemed and the entity fulfils its obligations to supply awards. The amount of revenue recognised is to be based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

If a third party supplies the awards, the entity is required to assess whether it is collecting the consideration allocated to the award credits on its own account or on behalf of the third party. In other words, it must assess whether it is acting as principal in the transaction or as an agent for the third party.

If the entity is collecting the consideration on behalf of the third party, it: measures its revenue as the net amount retained on its own account, i.e. the difference between the consideration allocated to the award credits and the amount payable to the third party for supplying the awards; and recognises this net amount as revenue when the third party is obliged to supply the awards and entitled to receive consideration for doing so. (These events may occur as soon as the award credits are granted. Alternatively, if the customer can choose to claim awards from either the entity or a third party, these events may occur only when the customer chooses to claim awards from the third party.)

If the entity is collecting the consideration on its own account, it measures its revenue as the gross consideration allocated to the award credits and recognises the revenue when it fulfils its obligations in respect of the awards.

## 3. Customer Loyalty Programmes in Romanian accounting system (RAS),

Starting with 2014 the accounting treatment for Customer Loyalty Programmes under RAS has changed.

The changes have taken into account to ensure a uniform accounting treatment for all economic operators, regardless of the applicable accounting regulations , respectively regulation of the Ministry of the Public Finances no. 3.055/2009 , with its subsequent amendments and additions (operators who report only under Romanian regulations), or regulation 1.286/2012, with subsequent amendments and additions (operators who report under international accounting standards).

Some entities may engage in customer loyalty programs, which involve the granting of gift points to their customers. These gift points can be used to purchase goods or free or reduced price services as part of a deal for the sale of goods or provision of services, subject to possible additional requirements. The organisation keeps an account of these gift points as an identifiable component of the transaction whereby they are granted (472 account "Deferred income" separate/analitic).

The corresponding amount of the gift points is recognized as income/revenue when the entity performs its obligation to deliver the awards or when the period of time during which customers can use the gift points expires. If it is estimated that the level of expenditure required to fulfil the obligation to provide the awards exceeds the value of the awards received or to be received, on the date on which the customer redeems the awards, the entity registers a provision for the corresponding difference.

According to the previous regulations of the Ministry of the Public Finances no. 3055/2009 revenue was recognized based on the gross size while for the corresponding amount of gift points a provision for risks and charges was considered.

***Example***

On 25.01.2014, the company A buys from company B goods worth 15.000 lei. According to its trade policy, company B gives customers who buy goods worth more than 10.000 lei a loyalty card which is debited with loyalty points on every purchase. When accumulating 2.000 points of loyalty, the customer receives a voucher in the amount of 400 lei, which can be used to purchase goods in a maximum period of 6 months from the date granted. As a result of the acquisition dated 25.01.2014, company A accumulated 300 loyalty points.

***Accounting treatment starting with 2014***

Registration of sale of goods in the accounts of company B:

| | | | |
|---|---|---|---|
| 4111<br>"Customers" | = | %<br>707 "Sales of goods purchased for resale"<br>472 "Deferred income" | 15.000<br>14.940<br>60 |

The deferred income is incurred/taken over to revenue of the period when the gift points are used or when the period expires. The evaluation of the gift points is done at the fair value.

***Accounting treatment before 2014***

According to regulation no 3055/2009, company B recorded the following:

| | | | |
|---|---|---|---|
| 4111<br>"Customers" | = | 707 "Sales of goods purchased for resale" | 15.000 |

and concomitant there was set up a provision for the loyalty points granted to company A

| | | | |
|---|---|---|---|
| 6812 "Depreciation and provisions; adjustments for impairment losses - operating expenses" | = | 151<br>"Provisions" | 60 |

60 lei = [(300 points x 100%)/2000 points] x 400 lei

Reward programmes essentially consist of promises made today to deliver something tomorrow, or next year, or potentially never. The nature of reward programmes often brings with it significant challenges. Many reward programs' structures are built around uncertain future events: contingencies of "how much," "when," and "if." Additionally, a programme's terms and conditions can change as the programme evolves, leading to material changes to the benefits that participating members can obtain, or to the costs that sponsors will encounter.

These uncertainties often obfuscate the value or costs that a sponsor is promising. Furthermore, these uncertainties can often challenge one's ability to estimate the future benefits and costs of a program in an accurate and substantive way.

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