Revenue recognition – how to account for free gifts and loyalty programmes

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IFRS 15 includes specific requirements related to "customer options for additional goods or services" – for example free gifts, discount vouchers, etc - and requires a distinction to be made as to whether this option confers a "material right". We will look at what is a "material right" and how do you make this assessment.

Performance obligations

One of the steps of IFRS 15 is the identification of performance obligations in the contract to enable the recognition of revenue. Performance obligations (POs) are promises to a customer that arise every time they enter a contract to supply a good or service. Not all POs need to be explicitly stated in the contract. Contracts may provide customers with the option to acquire additional goods or services either for free or at a discount through loyalty point programmes, customer award credits, sales incentives, contract renewal options, etc. Where the buyer has a valid expectation of an 'extra' or 'free' good or service being provided this is an additional PO and needs to be considered in the application of IFRS 15.

Material right

Retailers transfer goods directly to their customers on or close to the date the goods are paid for, so many retailers believe that the implementation of IFRS 15 will be straightforward. However, where incentives are offered, like free goods, coupons or loyalty points to keep customers returning this future offer is referred to as a material right under IFRS 15.

If the option provides a right the customer would not have received had they not entered into this contract, (e.g., a right incremental to the rights provided to other customers in the same region or market), the customer is in effect paying in advance for future goods and services. If such an option provides the customer with a "material right", then the option should be accounted for as a separate performance obligation.

> Entities may argue that the cost of the free goods is a marketing expenses. However, if a free good is promised to a customer, then it should be treated as a separate PO. A promise deemed to be free or deemed to be a marketing tool is probably a PO.

Accounting requirements

Once the determination has been made that a material right exists and it is a separate PO, a portion of the total transaction price must be allocated to this right. If the stand-alone selling price of the material right is not directly observable, it must be estimated. In determining this value, entities should factor into their estimate:

- any discounts that could be obtained without exercising the option
- the likelihood the option will be exercised..

How much is allocated to each item (or PO), will depend on how the transaction price is allocated.

Loyalty points are in substance the same as a coupon or free good. Some of the consideration received in exchange for the goods sold at the time when the points are earned should be deferred until the points are exchanged for goods or services in the future. The loyalty point is providing a right to a good or service to the customer, and therefore is a distinct PO.

Example - Free gift: *If a customer buys a football and receives a voucher for a free cap if they buy another football in the following month, part of the consideration for the initial football would need to be allocated to the free cap.*

What to consider?

In the process to determine when and how much revenue should be recognised, consideration should be given to all the promises being offered to the customer, those POs must be identified, including those which are implicit.

Example – Customer Loyalty Programme: *A customer loyalty programme rewards a customer with one loyalty point for every R10 of purchases. Each point is redeemable for a R1 discount on any future purchases. During a reporting period, customers purchase products for R100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed and the stand-alone selling price of the purchased products is R100,000. The entity expects 9,500 points to be redeemed. The entity estimates a stand-alone selling price of 95 cents per point (totalling R9,500) on the basis of the likelihood of redemption. It was concluded that the promise to provide points to the customer is a PO. The entity allocates the transaction price (R100,000) to the product and the points on a relative stand-alone selling price basis as follows:*

- *Product = R91,324 [R100,000 × (R100,000 selling price ÷ R109,500)]*
- *Points = R8,676 [R100,000 × (R9,500 selling price ÷ R109,500)]*

End of Year 1:

- *4,500 points have been redeemed and the expectation is still that 9,500 points will be redeemed in total.*
- *The entity recognizes revenue for the loyalty points of R4,110 [(4,500 points ÷ 9,500 points) × R8,676] and recognizes a contract liability of R4,566 (R8,676 less R4,110) for the unredeemed points at the end of the first reporting period.*

End of Year 2:

- *8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed.*
- *The entity recognizes revenue for the loyalty points of R3,493 {[(8,500 total points redeemed ÷ 9,700 total points expected to be redeemed) × R8,676 initial allocation] less R4,110 recognized in the first reporting period}.*
- *The contract liability balance is R1,073 (R8,676 initial allocation less R7,603 [R4110 + R3493] of cumulative revenue recognized).*