Customer loyalty programmes on credit cards

This article aims to:

Illustrate the accounting for customer loyalty programmes on credit cards under Ind AS 115.

Banks provide various incentives to credit card holders as part of their marketing scheme. Such schemes include cash-backs, complementary goods or services and other customer loyalty programmes, where award/loyalty points accrue to customers on each card swipe. These award points can then be redeemed by customers for various third-party goods or services.

Currently, under the Indian Generally Accepted Accounting Principles (GAAP), banks estimate the probable redemption of debit card and credit card award points using an actuarial method by employing an independent actuary. Provisions for such award points are recognised as per AS 29, *Provisions, Contingent Liabilities and Contingent Assets*.

Under Indian Accounting Standards (Ind AS), accounting for revenue and customer loyalty programmes would be governed by Ind AS 115, *Revenue from Contracts with Customers*[1]. Ind AS 115 provides a five-step model for revenue recognition, and also provides specific guidance for options provided to customers to purchase additional goods and services.

In this article, we aim to demonstrate the accounting, recognition and measurement of award credits granted by banks on credit cards as per the principles of Ind AS 115.

Example: Credit cards issued by bank A

The retail banking group of bank A (the bank) has issued different types of credit card to its select banking customers. In order to incentivise the use of the credit card, it has issued various schemes, including a customer loyalty programme. Schemes would vary for each type of credit card. In the current case, bank A considers its programme for 'silver' card-holders, where one reward point is allotted for every INR100 spent by the customer. 100 reward points are equivalent to INR20 (the value/price that the bank would pay a third party to take over the points liability). The bank has provided customers with a catalogue of products which are sold by a third party that is participating in the customer loyalty programme with the bank. Customers can redeem their reward points to purchase any of the products given in the catalogue. The number of points that need to be redeemed for each product has been specified against each product in the catalogue. While redeeming their award points, customers need to apply to bank A, either through a physical form, or through an online application. Reward points that would not be redeemed within two years of them being granted, will expire. The bank recovers 1.5 per cent of transaction price as interchange revenue on every card swipe.

1. Ind AS 115 was notified by the Ministry of Corporate Affairs on 28 March 2018, to be effective for accounting periods beginning from 1 April 2018.

While finalising its financial information for the month of April 2019, bank A observed that it had earned an interchange fee of INR100 million on ‘silver’ credit cards, and 65 million reward points had been accrued to the ‘silver’ credit-card holders. On the basis of its historical experience, bank A expects 90 per cent of the total reward points granted during the month to be redeemed.

Accounting issue

Considering the complexity of credit card arrangements and the involvement of multiple parties, bank A should analyse the transaction, and evaluate all conditions specified in Ind AS 115, to determine:

- The ‘customer’ in the current transaction
- Whether loyalty points accrued to the card-holders would be a separate performance obligation, and what would be the transaction price allocated to that, and
- Whether bank A would be acting as a principal or an agent in the current transaction.

Accounting guidance and analysis

Ind AS 115 prescribes a five-step approach when determining the amount and timing of revenue.
Figure 1 below evaluates each of these steps in context of the above illustration.

Figure 1: Evaluation of the five-step model

STEP 1	STEP 2	STEP 3	STEP 4	STEP 5
Identify the contract with customer	**Separate performance obligation in the contract**	**Determine the transaction price**	**Allocate the transaction price to separate performance obligation**	**Recognise revenue**
Agreements with customers of customer are valid contracts	Separate performance obligation, if material right received by customer on entering into the contract	Generally, interchange fees received by a bank on every card swipe	Based on relative stand-alone selling prices of goods or services	Determine whether bank is a principal or an agent for third party goods

Source: KPMG in India’s analysis 2018, read with Insights into IFRS, KPMG IFRG Ltd’s publication, 14th edition, September 2017

Step 1: Identify the contract

In order to identify the contract, bank A is first required to determine the customer. With multiple parties involved in the transaction, it can be challenging to identify the party which is the customer. Depending on facts and circumstances of each case, card issuers may identify either the merchant, or the card holders as their customer[2].

In the current illustration, bank A is of the view that since the merchants bear the cost of interchange, at the time of swiping the card, they would be considered as the customer of the bank. The question then arises whether the arrangement to provide loyalty points to the card holders (who are not identified as customers within the contract) would be within the purview of Ind AS 115.

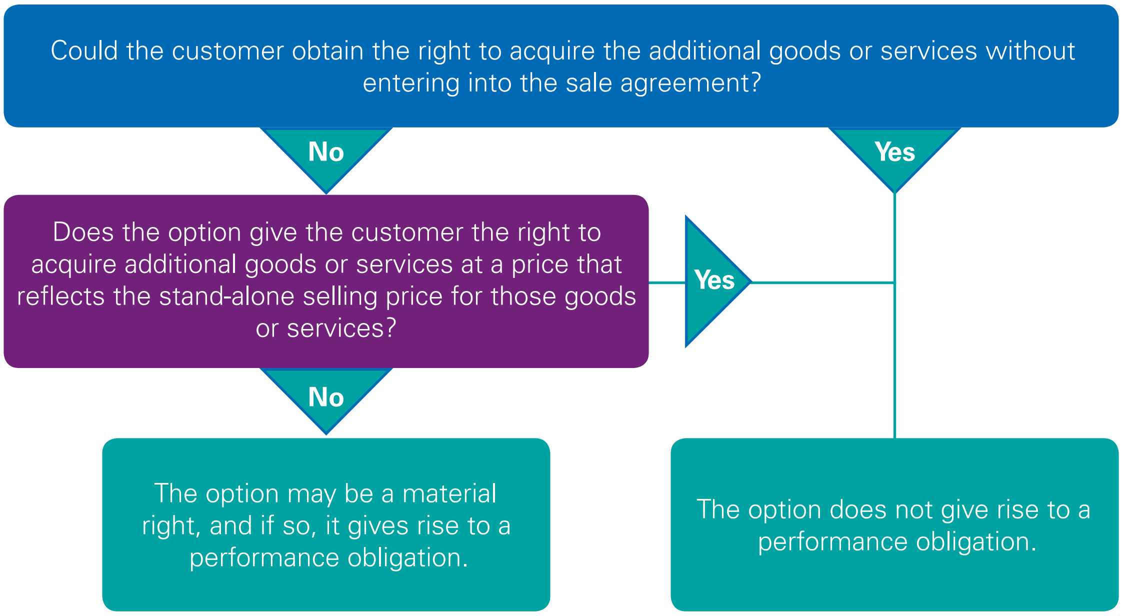
As per the Basis for Conclusions of IFRS 15, *Revenue from Contracts with Customers* (with which Ind AS 115 is converged), any promise to provide goods or services to the customer’s customer (in this case, the card holder), would be a valid performance obligation, within the context of this standard. Accordingly, though the customer in this case is the merchant, the agreement to provide reward points to the card holder would be accounted for in accordance with Ind AS 115.

Step 2: Identify the separate performance obligation in the contract

Ind AS 115 provides additional guidance on determining whether the customer options for additional goods or services would be considered as a separate performance obligation. This has been considered and evaluated in Figure 2 on the next page.

2. The view of the card issuer should be substantiated with reasons for the conclusion.

Figure 2: Determining whether customer options for additional goods or services are separate performance obligations



Source: Revenue Issues In-Depth, KPMG IFRG Ltd.'s publication, Second edition, May 2016

In the current case, the reward points granted to the card holders provide them with accumulated rights (material right), which can be used to purchase third party goods or services in the future at discounted prices, accordingly, the grant of such points are considered as a separate performance obligation.

Step 3: Determine the transaction price

When determining the transaction price for the reward points, card issuers are required to first determine the transaction that gives the card holders a right to receive the reward points. In the current illustration, card holders would receive a reward point on swiping of the card above a particular amount (INR100). Each card swipe would result in payment of interchange fees by the merchant to the bank. Accordingly, the transaction price may be considered as the interchange fees received by the bank.

Step 4: Allocate the transaction price to separate performance obligations

The transaction price is allocated to each performance obligation based on the relative stand-alone selling prices of the goods or services being provided. While the stand-alone selling price of the interchange fees would be the same as the transaction price (INR100 million), the stand-alone selling price of the reward points would be calculated on the basis of the likelihood of their redemption. Accordingly, the transaction price would be allocated between the service and the points on a relative selling price basis provided in the table below:

Amount (INR in million)

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Service[3]	100	89.5%	89.5	(100*89.5%)
Points	11.7[4]	10.5%	10.5	(100*10.5%)
Total	**111.7**	**100.0%**	**100**	

Source: KPMG in India's analysis, 2018

3. Service provided by the bank to the merchant for which interchange fees has been charged

4. 65 million points*(20/100) (INR20 for every 100 points accrued)*90% (likelihood of redemption)

Consideration of breakage while evaluating stand-alone selling price of reward points

Breakage refers to the portion of rights of customers (in this case card holders) which have not been/which are not expected to be exercised by them.

In the current illustration, bank A has considered 90 per cent of the total reward points to be redeemed, and thus has estimated the breakage to be 10 per cent. While estimating the breakage, the bank should ensure that there is a high probability that recognition of the breakage would not result in a significant reversal of revenue.

Step 5: Recognise revenue when (or as) each performance obligation is satisfied

The amount allocated to the service provided by the bank (INR89.5 million) should be recognised by it as revenue for the month of April 2019 (since the performance obligation is satisfied at a point in time). However, the accounting for the reward points granted to the customers would depend on whether the bank is acting as a principal or an agent while providing the customer loyalty scheme.

In the above illustration, bank A has the primary responsibility for fulfiling its promise to redeem the reward points, and deliver the third party goods to the card holders. At the same time, the bank has the discretion to set the price of the third party goods (based on the number of reward points that can be redeemed against each good). On evaluating the above factors, the bank determines that it obtains control of the third party goods (more than momentarily) prior to transferring those goods to the customer.

Basis this evaluation, it can be concluded that the bank is acting as a principal and accordingly, it will recognise revenue on gross basis, once the reward points are redeemed by the customer (at a point in time). In April 2019, it will recognise the amount allocated to the reward points (INR10.5 million) as a contract liability. The accounting entry for the transaction will be:

Date	Accounting entry	Dr/Cr	Amount (INR in million)
30 April 2019	Cash	Dr	100
	Revenue	Cr	89.5
	Contract liability	Cr	10.5

Consider this...

- When determining the stand-alone selling price of a customer option for additional goods or services, an entity estimates the likelihood that the customer will exercise the option (breakage). This initial estimate is not subsequently revised because it is an input into the estimate of the stand-alone selling price of the option. Under Ind AS 115, an entity does not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception. The customer's decision to exercise the option or allow the option to expire affects the timing of recognition of the amount allocated to the option, but it does not result in reallocation of the transaction price. However, an entity should continue to consider whether a provision for onerous contracts is required to be recognised.
- Sometimes coupons are handed over to the customers at the point of sale and these coupons are often a form of marketing offer. Typically, these coupons have little or no effect on the revenue accounting when they are granted. If there is no general marketing offer, then the entity assesses whether the coupon conveys a material right. This assessment includes consideration of the likelihood of redemption which will often be low, and therefore reduces the likelihood that the coupon will be identified as a material right. As a result, the coupons are often recognised as a reduction in revenue on redemption.
- Customer loyalty programmes generally do not include a significant financing component even though the time period between when the customer loyalty points are earned and redeemed may be greater than one year. This is because the transfer of the related goods or services to the customer i.e. use of the loyalty points — occurs at the discretion of the customer.