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Customer Loyalty Programmes

YOUR KEY TO THE TAX COMMUNITY

Welcome

Agenda

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2. Accounting concerns arising from customer loyalty programmes

3. Accounting guidance for customer loyalty programmes
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What is a customer loyalty programme?

The basic working of customer loyalty programmes

Why do entities use customer loyalty programmes (CLP's)?

- To increase customer loyalty to an entity
- To retain customers and grow sustainable income streams

How do CLP's work?

- Customers are rewarded for (qualifying) purchases made in terms of the loyalty programme

- Customers can be rewarded in many different ways, but the most common examples of such rewards are:
  - Loyalty points based on certain monetary amounts/values of goods and/or services already purchased
  - Discount coupons that can be applied to reduce the purchase price of goods and/or services acquired in future (i.e., future discounts)
  - Vouchers awarded that can be redeemed in future in exchange for certain goods and/or services

- The loyalty points, discount coupons and vouchers can be used to obtain goods and/or services at lower prices or completely free, **in future**

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Accounting concerns

arising from customer loyalty programmes

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- Assume an entity sells goods to the value of R500 (excluding VAT) to a customer.
- The customer is awarded loyalty points to the customer as follows: 1 loyalty point for every R50 spent (excluding VAT).
- The customer is therefore awarded **10 loyalty points** as part of the transaction, which can be utilised to pay for other goods acquired in future.

What are accountants concerned about?

1. What is the true substance of the above transaction?
2. Should the R500 be recognised in full when the goods are sold to the customer?
3. If not, what are the other account(s) affected by the transaction?
4. How are any other components in the transaction reliably measured?
5. What are the actual tax implications of the above transaction (income tax and VAT)?
6. Are there any deferred tax implications?

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Accounting guidance

for customer loyalty programmes

- Guidance is provided by IFRS 15 *Revenue from Contracts with Customers*
- IFRS 15 follows a five-step revenue recognition model, being:

  STEP 1: Identify a qualifying contract within the scope of IFRS 15

  STEP 2: Identify all the performance obligations ("promises") in the contract

  STEP 3: Identify the transaction price applicable to the transaction

  STEP 4: Allocate the identified transaction price to all the identified performance obligations per the contract

  STEP 5: Recognise the revenue applicable to each performance obligation over time or at a point in time

- *Is IFRS 15 applicable to SMEs, or should the IFRS for SMEs be followed?*

Material rights

arising from customer loyalty programmes

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- When the sale of goods and/or services provides a customer with an option to acquire additional goods and/or services for free or at a discounted price in future, the entity must firstly ascertain whether the sales contract provides the customer with a **"material right"**

- A material right is a right that gives the customer an option to acquire an additional good and/or service at a price that is lower than its standalone selling price

- The customer will not receive this right without entering into the initial sales contract

Was the customer given a "material right"?

NO ← → **YES**

Ignore the loyalty programme and recognise the full amount of revenue upon the sale of the initial good/service

The material right should be accounted for separately from the sale of the initial good/service

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Revenue allocation

in customer loyalty programmes

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Assuming a material right is transferred to the customer…

- IFRS 15 requires that the standalone selling price of the customer loyalty points, voucher, or discount be estimated
- Such an estimate includes:
  - The **benefit** attached to the actual points, voucher or discount; AND
  - The **likelihood** of the customer exercising/using the points, voucher, or discount
- The transaction price of the initial transaction is then allocated to the sale of the initial goods/services and the customer loyalty points, voucher, and/or discount based on the **relative standalone selling prices** of all the goods and/or services and/or loyalty points and/or vouchers and/or discounts that are present in the transaction
- The revenue relating to the sale of the initial goods and/or services is then recognised at the time of the transfer of the risks and rewards associated with ownership of the goods and/or services (i.e., according to normal revenue recognition principles), whereas the revenue relating to the loyalty points/voucher/discount is recognised as a contract liability (revenue received in advance from the customer)

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Example 1

The accounting for a customer loyalty programme

Ignore VAT for this example.

A customer acquires a foot spa at Glicks at its normal selling price of R500. The cost of the foot spa for Glicks is R350. As the customer is registered for the Glicks Frequent Buyer loyalty programme, the customer qualifies for 10 loyalty points in terms of this transaction.
Each loyalty point entitles the client to purchase goods to the value of R10 at a future date. There is a 90% likelihood that the customer will utilise the loyalty points before their expiry date, 12 months after their date of issue.

One month after the 10 loyalty points were awarded to the customer, the customer used the 10 loyalty points to acquire a shampoo bottle from Glicks. The normal selling price of the shampoo bottle is R100. The cost price of the shampoo bottle for Glicks was R60.

What are the accounting steps and related journal entries that Glicks should consider to appropriately account for the above transaction in their accounting records, if it is assumed that Glicks transferred a 'material right' to the customer in terms of the original transaction?

Example 1 – suggested solution

The accounting for a customer loyalty programme

Ignore VAT for this example.

Step 1: Estimate the standalone selling prices of the items in the transaction

➢ Foot spa: normal selling price	R500	85%
➢ Loyalty points: 10 points x R10 per point x 90% likelihood	R90	15%
➢ Total of standalone selling prices	R590	

Step 2: Allocate the revenue to the items based on their relative standalone prices

➢ Foot spa (R500/R590 x R500)	R424	85%
➢ Loyalty points (R90/R590 x R500)	R76	15%
➢ Total selling price allocated	R500	

Example 1 – suggested solution (cont.)

The accounting for a customer loyalty programme

Ignore VAT for this example.

Step 3: Process the journal entries at date of sale of foot spa, as follows:

Dr Bank	R500	
Cr Revenue (P/L) – sale of goods (foot spa)		R424
Cr Contract liability (SoFP) – received in advance		R76
Dr Cost of sales (P/L) – sale of goods (foot spa)	R350	
Cr Inventory (SoFP) – foot spa		R350

Step 4: Process the journal entries at subsequent date of use of the points to acquire shampoo, as follows:

Dr Contract liability (SoFP) – received in advance	R76	
Cr Revenue (P/L) – sale of goods (shampoo)		R76
Dr Cost of sales (P/L) – sale of goods (shampoo)	R60	
Cr Inventory (SoFP) – shampoo		R60

Interpretation note 118

Important definitions

"loyalty points" means miles, loyalty points or any other similar items (whether tangible or intangible) allocated to a member, which may be used by the member as payment for goods or services or entitle the member to any other benefit as a reward;

"loyalty programme" means any programme or scheme, with the characteristics set out in the next slide, under which the reward to the member is quantified using loyalty points (also referred to as a points-based loyalty programme)

Characteristics of loyalty programmes

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ALL of the following:

- Membership to a loyalty programme is open to any customer of an entity or group of entities, or to the public as a whole
- Members are entitled to be allocated a reward in the form of loyalty points as a result of their membership to the loyalty programme. The reward is quantified based on, amongst others, the value of goods or services acquired from certain entities, the promotion of a specific behaviour by the member (for instance, the use of a specific type of card) or purely because of being a member of the loyalty programme
- The member is not liable for any additional payment or consideration before becoming entitled to the loyalty points (excluding the membership fee where applicable)
- Members may in some instances pay less for goods or services than other customers. However, at no point should members pay more for goods or services than other customers or pay an additional amount that could be construed as being consideration for the allocation of loyalty points.
- Loyalty points allocated have a value attached to it, whether specific or notional.
- The loyalty points can be redeemed by the member for goods or services with a value similar or equal to the fair value of the loyalty points used as payment for the said goods or services

IN 118 Example

Example 1

A purchases goods from Retailer Y to the value of R1 150 (including VAT).
This purchase entitles A to 50 loyalty points by virtue of it being a member of the loyalty programme administered by Retailer X, being the LPO.
Each loyalty point is worth 20c to A.

What are the output tax consequences for Retailer Y?

Result: Retailer Y is required to account for and declare the VAT levied on the supply made to A.
The VAT amount is R1 150 × 15 / 115 = R150.

IN 118 Example

Example 2

Retailer X, being the LPO, is required to allocate 50 points to A because of eligible purchases made by A at Retailer Y.

What are the VAT consequences on the allocation of loyalty points by Retailer X to A?

Result: The value of the loyalty points allocated to A is nil.
As a result, the allocation of loyalty points has no output tax implications to Retailer X.
Retailer X may, however, deduct any VAT incurred as input tax in allocating the loyalty points to A to the extent that such allocation of loyalty points form part of Retailer X's enterprise activities, such as managing the loyalty programme for which a management fee is charged.

IN 118 Example

Example 3

A has accumulated 5 000 loyalty points over the past few months and decides to use these loyalty points when making the next purchase at Retailer Z, a redemption partner in the loyalty programme administered by Retailer X (being the LPO).
Each loyalty point is worth 20c to A.
A acquires taxable services from Retailer Z to the value of R2 500 and redeems all 5 000 loyalty points, with a value of R1 000. A therefore has to make an additional payment of R1 500.

What are the VAT consequences of the sale made by Retailer Z?

Result: The supply of the services made by Retailer Z is subject to VAT at the appropriate rate.
The consideration for the supply includes both the value of the loyalty points (being R1 000) and the consideration in money (R1 500).

The Clicks case

Final outcome

- Can section 24C be claimed?
  - Income received in advance and future expenditure i.t.o. contract
  - Can claim allowance although cost is not actually incurred yet

- **Tax Court** in favour of Clicks – section 24C can be claimed

- **Constitutional Court** in favour of SARS and disallows section 24C allowance
  - Unanimous decision
  - Reality: Two different contracts (i.e. transactions) that are independent of each other and have different terms and conditions
    - Original sale
    - ClubCard points exchange

Example 2

The accounting for a customer loyalty programme

Incorporate VAT at 15% in this example.

A customer acquires a foot spa at Glicks at its normal selling price of R575 (including VAT at 15%). The cost of the foot spa for Glicks is R350 (excluding VAT).
As the customer is registered for the Glicks Frequent Buyer loyalty programme, the customer qualifies for 10 loyalty points in terms of this transaction.
Each loyalty point entitles the client to purchase goods to the value of R11,50 (including VAT at 15%) at a future date.
There is a 90% likelihood that the customer will utilise the loyalty points before their expiry date, 12 months after their date of issue.

One month after the 10 loyalty points were awarded to the customer, the customer used the 10 loyalty points to acquire a shampoo bottle from Glicks. The normal selling price of the shampoo bottle is R115 (including VAT at 15%). The cost price of the shampoo bottle for Glicks was R60 (excluding VAT).

What are the accounting steps and related journal entries that Glicks should consider to appropriately account for the above transaction in their accounting records, if it is assumed that Glicks transferred a 'material right' to the customer in terms of the original transaction?

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Example 2 – suggested solution

The accounting for a customer loyalty programme

Incorporate VAT at 15% in this example.

Step 1: Estimate the standalone selling prices (including VAT) of the items in the transaction

➢ Foot spa: normal selling price	R575,00	85%
➢ Loyalty points: 10 points x R11,50 per point x 90% likelihood	R103,50	15%
➢ Total of standalone selling prices	R678,50	

Step 2: Allocate the revenue (excluding VAT) to the items based on their relative standalone prices

➢ Foot spa (R575,00/R678,50 x R500)	R424	85%
➢ Loyalty points (R103,50/R678,50 x R500)	R76	15%
➢ Total selling price (excluding VAT) allocated	R500	

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Example 2 – suggested solution (cont.)

The accounting for a customer loyalty programme

Incorporate VAT at 15% in this example.

Step 3: Process the journal entries at date of sale of foot spa, as follows:

Dr Bank	R570	
Cr VAT control account (output VAT) (R570 x 15/115)		R70
Cr Revenue (P/L) – sale of goods (foot spa)		R424
Cr Contract liability (SoFP) – received in advance		R76
Dr Cost of sales (P/L) – sale of goods (foot spa)	R350	
Cr Inventory (SoFP) – foot spa		R350

Step 4: Process the journal entries at subsequent date of use of the points to acquire shampoo, as follows:

Dr Contract liability (SoFP) – received in advance	R76	
Cr Revenue (P/L) – sale of goods (shampoo)		R76
Dr Revenue (P/L) – sale of goods (shampoo) (R115 x 15/115)	R15 (value of supply = market value)	
Cr VAT control account (output VAT)		R15
Dr Cost of sales (P/L) – sale of goods (shampoo)	R60	
Cr Inventory (SoFP) – shampoo		R60

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