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## IFRIC 13 Customer Loyalty Programmes

Its effects on the information quality of companies' accounting

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Autumn 2007



## Abstract

Bachelor thesis in Business economics, Financial accounting, The School of Business, Economics & Law, Göteborg University, Autumn 2007.

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**Title:** IFRIC 13 Customer Loyalty Programmes, its effects on the information quality of companies' accounting.

**General description of the research problem:** When accounting for customer loyalty programs today, companies have to follow the rules of IAS 18 which offers two ways of accounting. The companies can follow paragraph 13 or paragraph 19 and therefore practice is varying and the companies' accounting is not comparable. IFRIC has developed IFRIC 13 Customer Loyalty Programmes that regulate these programs so that they can be accounted for in an equal manner. The European Union has not yet approved IFRIC 13 but it is most likely that it will be accepted and implemented. IFRIC has received several comments regarding IFRIC 13 from different companies and organisations that have expressed their dislike for the Interpretation.

**Purpose of the study:** To study how companies account for customer loyalty programs today and then analyse what effects will arise in the information quality of the financial statements when companies will be required to use IFRIC 13.

**Research methods:** In order to achieve our purpose we have interviewed three companies with customer loyalty programs and two accounting specialists with experience from accounting customer loyalty programs. To reach a better understanding of IFRIC 13 we have collected data from books, articles and web pages. When analyzing the empirical material we have been influenced by the chosen theories.

**Results and conclusion:** Three out of four of the companies studied use paragraph 19 when accounting for customer loyalty programs. When implementing IFRIC 13 the reliability of the accounting will decrease since the companies have to make additional estimations. The validity of the information quality will both increase and decrease when implementing IFRIC 13 depending on the point of view. It is not possible to make a conclusion regarding the validity of the companies' accounting. The result will depend on the nature of the companies' customer loyalty programs. The comparability will increase when implementing IFRIC 13. However, this result is depending on the interpretation and the implementation of IFRIC 13. The effects on the information quality will be dependent on the value of the revenue amount of the customer loyalty programs.

**Suggestions for further studies:** Since IFRIC 13 is not yet implemented it would be interesting to repeat this study once it has been implemented and been in use for a while. It would also be interesting to carry out a study of the airline industry to see if the effects arising from IFRIC 13 are really as essential as they claim.



## Preface

*We would like to thank all the respondents who have taken part in our study. Without your help we would not have been able to perform this study.*

*We would also like to thank Pernilla Lundqvist who has introduced us to IFRIC 13 and helped us with the interpretation.*

*Finally we would like to thank our tutor Märta Hammarström, and Inga Lill Johansson who have helped us to pass all the obstacles that have arisen during the writing of this thesis. Thank you for all your help.*

*Göteborg 10 January 2008*

.....  
**Linda Johansson**

.....  
**Jeanette Ringius**



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## 1. Introduction

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*This chapter begins with an introduction to the topic of the study followed by a general description of the problem, which leads to the purpose of the study. The delimitation of the study is the concluding part of this chapter.*

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### 1.1 Background

The European Union approved in 2002 an international accounting regulation which resulted in comprehensive changes for all listed companies on regulated markets. This regulation required that these companies, in their consolidated financial statements, follow the standards created by the International Accounting Standards Board (IASB), starting in 2005 (Smith 2006). IASB is an independent organisation that works as an international accounting standard-setter. The organisation consists of 14 board members from nine different countries and with a variety of professional backgrounds. IASB is funded by contributions from the major accounting firms, private financial institutions and industrial companies all over the world, central and development banks etc. The contributions are collected by its Trustees, the International Accounting Standards Committee Foundation (IASC Foundation, [www.iasb.org](http://www.iasb.org): About IASB).

IASB's main purpose is to establish a uniform set of "high quality, understandable and enforceable global accounting standards" ([www.iasb.org](http://www.iasb.org): About IASB) due to higher demand for financial information that is of "high quality, transparent and comparable" ([www.iasplus.com](http://www.iasplus.com), IASB). To achieve convergence in accounting standards around the world, IASB needs to cooperate with national accounting standard-setters ([www.iasb.org](http://www.iasb.org), IASB). The international accounting standards that are supposed to be followed are International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS). The difference between them is the time they were approved. IAS are standards proclaimed before July 2003 and IFRS after ([www.iasplus.com](http://www.iasplus.com), IASB).

International Financial Reporting Interpretations Committee (IFRIC) is an interpretative body of the IASB. It consists of 12 members from different countries and different professional backgrounds. IFRIC examines and reviews IFRS and the IASB framework and announces interpretations in accounting issues that are likely to receive divergent or unacceptable accounting behaviour due to the absence of authoritative guidance ([www.iasb.org](http://www.iasb.org), IFRIC 13: Press release).

The developing process of an IFRIC starts with an interpretation that is exposed to public comments. These are called "Draft Interpretations" and are numbered D1, D2, etc. After receiving comments and taking them into consideration IFRIC approves the interpretation when consensus is reached. This takes place when nine members or more of the board are in favour of the proposal ([www.iasplus.com](http://www.iasplus.com), IFRIC). In this process of developing interpretations, the IFRIC



is closely connected to similar national interpretation committees. ([www.iasb.org](http://www.iasb.org), IFRIC 13: Press release). After consensus is reached the Interpretation needs to be approved by the IASB ([www.iasplus.com](http://www.iasplus.com), IFRIC). In the end it is the European Commission who decides if the Interpretation shall be realised among the members, with advice from the European Financial Reporting Advisory Group (EFRAG). EFRAG operates through a technical expert group (TEG) that consists of working groups within different specialist areas ([www.efrag.org](http://www.efrag.org), EFRAG Facts & About TEG).

## 1.2 General description of the research problem

IAS 18 regulates revenues and states how they should be accounted for. IFRIC has identified a problem with this standard regarding customer loyalty programs. IFRIC's definition of customer loyalty programs is when companies reward customers, who buy goods or services, with loyalty award credits (such as "points" or travel miles). Paragraph 13 and paragraph 19 in IAS 18 describe two different ways of accounting for customer loyalty programs, something which results in a lack of guidance and varying practice. To solve this problem IFRIC started to develop a new Interpretation. A Draft Interpretation called D20 was established and exposed for public comments which were taken under consideration by the body. After that IFRIC 13 was established and approved at IASB's meeting in June 2007. IFRIC 13 Customer Loyalty Programmes will standardize the accounting of customer loyalty programs. IFRIC 13 will be mandatory starting 1<sup>st</sup> July 2008 ([www.iasb.org](http://www.iasb.org), IFRIC 13: Press release).

IFRIC has received several comments regarding IFRIC 13 from different companies and organisations who have expressed their dislike for this Interpretation. We assume that IFRIC 13 will lead to changes in the information quality of the companies' financial statements. We expect that one way of accounting will lead to a more comparable accounting and the use of fair value will lead to a less reliable accounting. We also assume that IFRIC 13 will lead to a more valid accounting.

The questions we aim to answer are:

How do companies account for their customer loyalty programs?

How will IFRIC 13, Customer Loyalty Programmes, affect the information quality of the financial statements?

## 1.3 Purpose of the study

The purpose is to study how companies account for customer loyalty programs today and then analyse what effects will arise in the information quality of the financial statements when companies will be required to use IFRIC 13.



## 1.4 Delimitations

Since we have had limited resources to perform the study we have focused on interviewing three companies and two accounting specialists. The purpose of the study has not been to generalize the way that companies account for customer loyalty programs, but to show the changes that will arise for the companies that account in the same way as the studied ones. The three chosen companies might execute their accounting in different ways. If this is the case, IFRIC 13 will affect the information quality of their financial statements in different ways.





## 2. Research methods

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*In this chapter we will describe and explain the methods chosen for the study. We will also explain our selection of companies and respondents and give details regarding the collection of data. Finally we will state the validity and the reliability of the methods and resources chosen.*

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### 2.1 Research design

Our first encounter with the problem mentioned above arose during a lecture regarding revenue accounting held by Pernilla Lundqvist, KPMG. We have since then been in contact with her to increase our knowledge of the problem before deciding the purpose of our essay. The fact that IFRIC 13 is a current phenomenon and there has been no research done in this specific field makes it an interesting subject.

Since the objective of our study is to attain a better understanding of and give a description of the accounting of customer loyalty programs we decided to perform interviews with the companies concerned. We have also performed interviews with accounting specialists since they might have more knowledge of IFRIC 13. To attain a better understanding of the phenomenon we have collected data from books, articles, and web pages. Within the section containing the analysis we have used the theoretical framework to analyse the empirical findings. The results from the analysis are described in the conclusion.

### 2.2 Selection of companies and respondents

The selection of companies was primarily based on the fact that they use customer loyalty programs and secondly on the fact that they are users of IAS/IFRS proclaimed by the European Union. The number of industries that use customer loyalty programs is limited. When looking at the Swedish stock market we were able to identify the three most common ones. The identified industries are the hotel business, transportation, and the retail industry. The reason for choosing companies from different industries is the assumption that their customer loyalty programs differ and therefore the accounting might be diverse. Our intention was to choose three companies, one in each industry, but since it was difficult to find a hotel suitable to our requirements we have chosen to study the transportation and the retail industries. When possible, the selection was based on the position of their headquarters in relation to Göteborg since our objective was to perform face-to-face interviews. Lindex has its headquarter in Göteborg and was therefore the company chosen to represent the retail industry. Since we were not able to use the hotel industry we have chosen to study yet a company within the retail industry. Lindex is within the clothing industry so we have chosen to select the second company from the convenience goods industry. We were not able to find a convenience goods chain with headquarters in Göteborg so we had to



start looking in Stockholm. ICA, a convenience goods chain with customer loyalty programs and using IAS/IFRS, came to be the second company. In order to study the Swedish stock market, SAS is the company that will best represent transportation since the airline industry is one of the most common users of customer loyalty programs. Unfortunately, we were not able to get in touch with a person within SAS, suitable for our study. The other Swedish transportation company using IAS/IFRS, which we could think of, was SJ. SJ became the third company that we decided to interview. Since we have found a lot of information about the manner in which airline industry uses customer loyalty programs, as well as the consequences for the companies' accounting of IFRIC 13, we decided to include Finnair, British Airways and South African Airways in our study. These will in the study be referred to as one company, the airline industry.

To summarize, the three companies chosen for interviews in our study are Lindex, ICA and SJ. The airline industry has been a part of our study even though no interviews were performed. The selection of respondents in the companies interviewed was based on their practice in accounting for customer loyalty programs. We were aware that some respondents would be able to give us information about how they account for customer loyalty programs today, but they might not have any knowledge of IFRIC 13. If this had been the case, then we would have sent them information about the new interpretation before the interview. Even though they would receive this information, they might still not be able to contribute in this matter. Therefore, we chose to also perform interviews with two auditors and one accounting specialist. The selection of the auditors and the accounting specialist was based upon their practice in accounting for customer loyalty programs, in businesses that resemble the ones that we have based our study on, and their knowledge of IFRIC 13.

We selected auditors and an accounting specialist from three of the largest audit firms in Göteborg. The audit firms chosen were KPMG, Ernst & Young and Öhrlings Pricewaterhouse Coopers. We have decided not to interview Pernilla Lundqvist, KPMG, because we wanted to have the possibility to discuss IAS 18 and IFRIC 13 with her. When we started contacting respondents from audit firms we promptly realised that the auditors did not have sufficient knowledge of IFRIC 13. The interviews were therefore performed only with accounting specialists. Since IFRIC 13 is not yet implemented it was difficult to find respondents that have the knowledge required for our study. This and the fact that we after two interviews found that we received the same answers we decided not to perform any further interviews. The respondents interviewed are working at Ernst & Young and Öhrlings Pricewaterhouse Coopers. After performing the interview with Lindex we received information that the company has been bought up and are now working with a harmonization of the accounting. We have therefore not been able to use the collected information from them regarding effects arising with IFRIC 13. This has not in any major way affected the study.

## 2.3 Collection of data

The interviews were performed face-to-face and had a high level of standardisation and structure. The reasons we have chosen face-to-face interviews were that it gave us the possibility to observe the respondent which made the probability of misunderstandings lower. The interviews had a



high standardisation and structure since it was important for us to get specific information in order to answer our research problem. Even though the interviews were highly structured and standardized we asked additional questions that arose during the interview. Before the interviews we made sure that the respondents understood the purpose of our study. Comprehensive questions were sent beforehand so that the respondents would be able to prepare. The interviews were, with the respondents' consent, recorded. The interviews were transcribed afterwards. If additional questions have arisen during the process they were added in upcoming interviews. The interviews with ICA and SJ were performed in Stockholm while the three remaining interviews were performed in Göteborg.

To be able to write the different chapters of the thesis we have collected data from books, articles, and web pages. We have used search engines such as Google and Gunda to search for words as IFRIC 13, IAS 18, customer loyalty programs, revenue accounting, communication theory, relevance, validity, reliability and comparability. The collected material was based on its possibility to give us further understanding of the phenomenon studied. We ended the information search when we had reached a magnitude that kept us from attaining further understanding of the problem. To be well prepared for the interviews we looked into the companies' customer loyalty programs. The information was gathered from their web pages. When no reference has been added regarding the information of the companies studied, then we have collected the information from their web pages. Since IFRIC 13 is not yet implemented the information available is only attainable from web pages.

## **2.4 Validity and reliability**

Validity is the most important requirement when measuring something. The validity of the study requires that we study what we have aimed to study (Eriksson & Wiedersheim 2006). To obtain a high validity of the study we accurately selected interview questions corresponding to the purpose of our study. Since interview questions and the purpose of our study were sent out to the respondents before the interviews we made sure that the respondents chosen were suitable for the study. To increase the validity the questions for the interviews were formulated so that the respondents had the possibility to answer freely. The interviews took place at the respondents' workplace because this is a place where they feel comfortable. It is easy for the researcher to affect information unconsciously and also to overlook information in an interview (Befring 1994). We therefore recorded every interview and after the interview we transcribed it word for word.

Since interviews can have an error value it is important to make sure that the study reaches a high reliability (Ekengren & Hinnfors 2006). To obtain a high reliability in the study we have both recorded and taken notes during the interviews, and then compared the results. We have tried not to use questions that are too long, leading, presupposed, or questions that contain negations. We started and ended the interviews with neutral questions in order to make our respondents feel comfortable. During the interviews we have tried to behave in a way so that the respondents would understand what was expected of them. When questions have arisen regarding answers from the interviews we have sent e-mails to the respondents for further information.



One thing that may affect the reliability negatively in our study is that the results we received from the interviews were based on the moment when we carried out the interviews. In the case of this study IFRIC 13 is not yet implemented which results in that questions regarding this will be based on assumptions, with subjective judgements and attitudes. In order to make sure that we have interpreted IFRIC 13 correctly we had a second meeting with Pernilla Lundqvist at the end of the thesis period. The meeting was held in order to increase the reliability of the data collected regarding IFRIC 13 and IAS 18.

It is important to be critical of the sources used in the study. If the study is to be reliable the sources have to be carefully selected. The data used in this study was collected from often-used and established sources. Since it is more difficult to establish the reliability of the information collected from web pages we carefully made sure that the information collected comes from trustworthy sources. With help from a course in information search, held by Eva M Johansson, librarian at Göteborg University Library, we were able to search for information from reliable sources. We have searched for articles in databases such as Business Source Premier and JSTOR. When looking through the data collected we have tried to use the original sources when these were available.



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## 3. Regulations

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*In this chapter we will describe the regulations concerning accounting of customer loyalty programs. First we will describe IAS 18 Revenues and then IFRIC 13 Customer Loyalty Programmes.*

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### 3.1 IAS 18 Revenues

IAS 18 prescribes how revenues from certain types of transactions and events should be accounted for. Revenues are defined in paragraph 7 as “the gross inflow of economic benefits arising in the course of the ordinary activities of an entity...” Paragraph 9 clarifies that the received consideration should be measured upon the fair value. Fair value is defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”

IAS 18 describes and determines when to recognize revenues. This is clarified in the standard as “when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably”. IAS 18 describes circumstances in which these criteria occur and a guide for application. Circumstances are described as when “revenues arise from the sale of goods, the rendering of service, the use by others of entity assets yielding interest royalties and dividends”.

According to IAS 18 paragraph 14, “revenues from the sale of goods shall be recognised when all the following conditions have been satisfied:

- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the entity; and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.”

The following criteria, according to IAS 18 paragraph 20, need to be reached to achieve recognition of the revenue arising from the rendering of service:

- “the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the entity;
- the stage of completion of the transaction at the balance sheet date can be measured reliably; and
- the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.”



Customer loyalty programs generate revenues and shall therefore follow IAS 18. Companies today are allowed to account for these programs in two different ways described in paragraph 13 and 19. Paragraph 13 prescribes that each transaction is usually applied separately but “in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction“. This occurs for example when service is included in the selling price but also when an entity is using customer loyalty programs. The accounting according to customer loyalty programs should be performed in the following way. A company sells goods for 100 Swedish crowns and the customer collects 1 Swedish crown in bonus. Because 1 Swedish crown can be separately identified it should be accounted as revenue when the bonus is redeemed. In this case the amount accounted as revenue is 99 Swedish crowns.

Paragraph 19 requires companies to account revenues and costs from the same transaction at the same time. This can be done when the criteria for revenue accounting are reached and when expenses can be identified in a reliable way. Under conditions, when costs cannot be identified in a reliable way, possible receivable compensations for selling of goods are accounted as a debt. When the points are redeemed and the “free” goods are given to the customer the expense is often accounted as a marketing cost. Applying the same example mentioned before to paragraph 19, the 100 Swedish crowns at the first purchase will be accounted as revenue.

## 3.2 IFRIC 13 Customer Loyalty Programmes

In this part we will describe the issues and the basis for conclusions of IFRIC 13. We will state the comments made on IFRIC 13 by national standard setters, large auditing firms, auditing bodies and preparers of accounts.

### 3.2.1 IFRIC 13 Issues and basis for conclusions

#### *Background*

According to IFRIC 13 the purpose of companies in having customer loyalty programs is to encourage the customers to buy their goods and services. The award credits collected by the customer can be used to receive free goods and services or a discount on these. The customer loyalty programs can be of a different nature. Some can require the customers to collect a specific amount of award credits before deferring them. The awards deferred can be supplied by the company or by a third party. IFRIC 13 applies to customer loyalty programs that grant their customers awards, such as points, when buying goods or services ([www.fwsb.de](http://www.fwsb.de), IFRIC 13 Customer Loyalty Programmes). “IFRIC 13 applies only if the rights to free or discounted goods or services are granted to customers *as part of a sales transaction*” ([www.iasb.org](http://www.iasb.org), Questions and answers p.1).



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## *Issues*

IFRIC 13 handles whether the company should account the supplying of awards as a cost or allocate some of the consideration received to the award credits, deferring the recognition of revenue. The consideration allocated to the award credits will be seen as a liability towards the customer. If IFRIC consent that the consideration should be allocated to the award credits, then there has to be reflections as to which amount of consideration should be allocated. There also have to be reflections as to when the revenue should be recognised and how the revenue should be measured if the awards are supplied by a third party (ibid).

## *Accounting method*

As mentioned before there are two ways of accounting for customer loyalty programs when following IAS 18. In favour of the view where the obligation is seen as an expense directly at the sale and measured as the cost of fulfilling the obligation, is that the costs are seen as marketing expenses. The customer loyalty programs are used to increase sale and should therefore be seen as marketing tools. This means that, according to IAS 18, the obligation to the customer is fulfilled at the initial sale. (ibid) “Paragraph 16 of IAS 18 indicates that a selling company can recognise revenue before it has completed all of the acts required of it under the contract, providing it does not retain the significant risks and rewards of ownership of the goods sold.” Even though obligations are not fully completed the future costs should be recognised following the recognition of revenue (ibid).

The second view is as mentioned before that the consideration received should be allocated between the goods and services sold and the award credits. The consideration belonging to the award credits should be deferred until they are redeemed. In favour of this view is that award credits are a part of the sale and a component that the customer is paying for. It is possible to separate the award credits from goods and services sold. (ibid)

The third view is that both methods should be used depending on the nature of the customer loyalty program. The criteria could be based on the significance of the award credits in relation to the goods and services sold and depending on the method used to fulfil the obligation. (ibid)

The consensus of IFRIC is that a company should use paragraph 13 of IAS 18 when accounting for customer loyalty programs. “IFRIC 13 is based on a view that customers are implicitly paying for the points they receive when they buy other goods or services, and hence that some revenue should be allocated to the points” (www.iasb.org, IFRIC 13 Customer Loyalty Programmes, p. 1). The award credits should be seen as a separate identifiable component of the initial sale. They are not, as according to the first view, costs that directly can be connected to the already delivered goods and services. The third view could lead to difficulties in the accounting since the company may have different choices of awards with different natures. Two choices of accounting would not lead to a better comparability. (www.fwsb.de, IFRIC 13 Customer Loyalty Programmes)



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### *Allocation method*

The consideration allocated to the award credits is equal to the fair value of the consideration received for them. Since it is sometimes hard to observe the fair value of the award credits it is under these circumstances permitted to use an appropriate allocation method when allocating the consideration between the award credits and the other components of the sale. There is no description of how to allocate consideration for multiple-component sales. However, the overall objective of IAS 18 is that the allocation of the consideration should be made considering the amount for which the components could be sold separately. The amount of each component could be determined by comparing with transactions made by similar customers. There is no specification saying whether the consideration received should be allocated to the award credits equal to their fair value or to its fair value in relation to the fair value of the goods and services in the same transaction. It is up to the management's judgement what method to choose (ibid).

### *Application guidance*

The estimation of the fair value can be made with reference to the discount that the customer will generate when redeeming the award credits. Factors that need to be taken into account when using the future discount as reference are the expected award credits being redeemed and discounts offered to customers without them having earned award credits from an initial sale. If there is a possibility for the customer to choose between different awards, the judgement of the fair value must consider the probability for each discount to be selected (ibid).

### *Revenue recognition for awards supplied by the entity*

The award credits should be recognised as revenue when the company has fulfilled its obligation, which is when the customer has redeemed its awards. The amount of revenue recognised depends on the award credits redeemed in relation to total expected award credits to be redeemed. There are occasions when the company changes the expected number of award credits being redeemed. The changes do not affect the consideration received at the initial sale but changes the revenue recognised concerning the award credits being redeemed in that period (ibid). "The change in expectations is thus accounted for as a change in estimate in the period of change and future periods, in accordance with paragraph 36 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*" (www.fwsb.de, IFRIC 13 Customer Loyalty Programmes p. 17). The increase of expected redemption could lead to that the cost of fulfilling the obligation for the awards exceeds the received consideration and the expected consideration to be received. If this is the case, then the company has an arduous contract. The excess is to be seen as a liability according to IAS 37 (www.fwsb.de, IFRIC 13 Customer Loyalty Programmes).

### *Revenue recognition for awards supplied by a third party*

When the awards are supplied by a third party there is a difference in accounting depending on whether the company collects the consideration on its own account or allocates it to the awards on behalf of the third party. When the consideration is collected on the company's account the gross consideration is allocated between the award credits and other goods and services sold.





Revenue for the company is the same as the gross consideration allocated to the award credits. Revenue is recognised when the company has fulfilled its obligation towards the awards. If it collects the consideration on behalf of a third party the company has to account the revenue as the net value of the award credits granted and the sum paid to the third party. The revenue should be recognised when the third party takes over the obligation towards the customer and for this receives a consideration. The essence of the agreement between the company and the third party controls at what point the third party takes over the obligation towards the customer. The obligation can be taken over directly when granting the award credits or, if the customer can choose to redeem the awards from the company or the third party, first when the customer chooses to claim awards from the third party (ibid).

#### *Implementation date*

The date chosen for IFRIC 13 to be initiated is July 1<sup>st</sup>, 2008. IFRIC allows earlier application of the interpretation but if application is done before July 1<sup>st</sup> that information needs to be noticed. The transition should follow the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. (ibid)

#### *An Illustrative example of IFRIC 13 Customer Loyalty Programmes*

“If your company runs a loyalty programme, IFRIC 13 requires you to treat part of the payment you receive for the goods or services you provide to customers as a liability to your customer and show it as such in your company’s accounting. For example, when your customer spends \$100 on groceries and is granted 100 points, worth \$0.01 each, you have to allocate \$99 of the cash to the groceries already sold to the customer and \$1 to the points. Consequently \$99 of revenue is recorded immediately, but \$1 is held back (i.e. shown as a liability) until your customer redeem the points and you have to supply the ‘free’ groceries. Until now many companies have measured the liability differently. They have measured it as a cost of supplying the free groceries, which would normally be less than the \$1 that the customer would have paid for them” (www.iasb.org; Question & Answers pp. 1-2.).

#### *Illustrative examples from IFRIC 13 Customer Loyalty Programmes*

##### Example 1-Awards supplied by the entity

A grocery retailer operates a customer loyalty program. It grants program members loyalty points when they spend a specified amount on groceries. Program members can redeem the points for further groceries. The points have no expiry date. In one period, the entity grants 100 points. Management expects 80 of these points to be redeemed. Management estimates the fair value of each loyalty point to be one currency unit (CU1), and defers revenue of CU 100.

##### Year 1

At the end of the first year, 40 of the points have been redeemed in exchange for groceries, that is half of those expected to be redeemed. The entity recognises revenue of  $(40 \text{ points} / 80 \text{ points}) \times \text{CU}100 = \text{CU}50$ .



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## Year 2

The second year, management revises its expectations. It now expects 90 points to be redeemed altogether. During the second year, 41 points are redeemed, bringing the total number redeemed to  $40+41=81$  points. The cumulative revenue that the entity recognises is  $(81 \text{ points}/90 \text{ points}) \times \text{CU}100 = \text{CU}90$ . The entity has recognised revenue of CU50 in the first year, so it recognises CU40 in the second year.

## Year 3

The third year, a further nine points are redeemed, taking the total number of points redeemed to  $81+9=90$ . Management continues to expect that only 90 points will ever be redeemed, that is that no more points will be redeemed after the third year. So the cumulative revenue to date is  $(90 \text{ points}/90 \text{ points}) \times \text{CU}100 = \text{CU}100$ . The entity has already recognised CU90 of revenue (CU50 in the first year and CU40 in the second year). So it recognises the remaining CU 10 in the third year. All of the revenue initially deferred has now been recognised.

## Example 2-Awards supplied by a third party

A retailer of electrical goods participates in a customer loyalty program operated by an airline. It grants program members one air travel point with each CU1 they spend on electrical goods.

Program members can redeem the points for air travel with the airline, subject to availability. The retailer pays the airline CU0,009 for each point.

In one period, the retailer sells electrical goods for consideration totalling CU1 million. It grants 1 million points.

### Allocation of consideration to travel points:

The retailer estimates that the fair value of a point is CU0,01. It allocates to the points 1 million  $\times$  CU0,01 = CU10,000 of the consideration it has received from the sales of electrical goods.

### Revenue recognition:

Having granted the points, the retailer has fulfilled its obligation to the customer. The airline is obliged to supply the awards and entitled to receive consideration for doing so. Therefore the retailer recognizes revenue from the points when it sells the electrical goods.

### Revenue measurement:

If the retailer has collected the consideration allocated to the points on its own account, it measures its revenue as the gross CU10,000 allocated to them. It separately recognises the CU9,000 paid or payable to the airline as an expense. If the retailer has collected the consideration on behalf of the airline, that is as an agent for the airline, it measures its revenue as the net amount it retains on its own account. This amount of revenue is the difference between the CU10,000 consideration allocated to the points and the CU9,000 passed on to the airline (www.fwsb.de, IFRIC 13 Customer Loyalty Programmes pp. 11-12).



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### 3.2.2 Comments on the draft

Before IFRIC 13 was adopted IFRIC published D20, a draft interpretation, in order to receive comments on it. The comments received can be divided into three different groups. The first group, consisting of most of the large auditing firms and auditing bodies, some national standard-setters, but very few preparers of accounts, were in favour of the draft. The second group opposed the draft and were in favour of the cost approach. This group consisted of preparers of accounts and some national standard-setters. The third group, consisting of preparers and some national standard-setters, were in favour of the accounting that depends on the nature of the customer loyalty program ([www.iasb.org](http://www.iasb.org), Information for observers).

IFRIC changed the draft after some comments, but here we will only address the comments that did not render a change in the draft. The changes made are minor, IFRIC kept the consensus of the draft since they did not find any of the comments persuading enough to change it (*ibid*).

The belief, of the once opposed to IFRIC 13, is that all or almost all customer loyalty programs have the substance of marketing expenses. Another view is that there is no reason for using the deferred revenue approach when the value of the award credits is insignificant. Others believe that IFRIC does not take into account that the customer loyalty programs might be of a different nature. The award credits can be a separate identifiable component, which is when the award is given in the course of the entities' ordinary activities, and as mentioned before occasional marketing costs. This should be taken into account when accounting for customer loyalty programs ([www.iasb.org](http://www.iasb.org), Comments).

Some believe that it is not right to make the companies carry out all the changes involved in applying a more complex approach when there is no framework that supports it. Since there is an ongoing project resulting in a new IFRS instead of IAS 18, there is no point in requiring the companies to use the deferred revenue approach. As far as it is known the new IFRS will set the course for a new development. It will among other things explain the separately identifiable components; this is one of the reasons resulting in the commentators opposing the consensus of IFRIC 13. More research has to be made before the deferred revenue approach could be accepted (*ibid*).

One of the concerns is that the consensus of IFRIC 13 is not based on clear principles. The financial information required from the users to make economic decisions should especially follow the qualitative characteristics relevance and reliability. The opposers do not believe this to be the case with IFRIC 13. The definition of fair value is not used in IAS 18 today and therefore it should not be used in IFRIC 13 (*ibid*).

Some commentators are not satisfied with the allocation of the award credits by their relative fair value. IFRIC says that when the fair value cannot be directly observed there has to be an estimation of it. This means that the reliability could deteriorate. The IFRIC takes a customer perspective when estimating the fair value while other standards make the valuation from the company's perspective (*ibid*).



The cost will increase but some are concerned that there will be no significant benefits arising from IFRIC 13. They doubt whether the relevance and the reliability will increase. Some say that the cost/provision approach is easier to apply and gives the same relevance and reliability in the financial information as the deferred revenue approach. Some companies will not have the structures and systems for implementing the consensus of IFRIC 13. (ibid)

EFRAG, which was one of the opponents in favour of the cost approach accounting and with many concerns about IFRIC 13 is today in favour of the consensus and recommends The European Union to apply it. The organization was at first criticised for not viewing the draft the way they were supposed to. The mission of EFRAG is to make sure that new rules comply with the qualitative characteristics of the framework. EFRAG has now concluded that this is the case with IFRIC 13 and is therefore in favour of it (ibid).

IFRIC was aware of the fact that the cost would increase in the beginning since the companies might have to change systems and procedures, but in the long run the costs would not exceed the benefits. According to IFRIC the estimations needed when allocating the amount of revenue to the awards, will be needed also when estimating the cost of fulfilling the obligation. The benefits for the users will arise since the obligations of customer loyalty programs will be accounted for equally to the obligations of other separable components (www.fwsb.com, IFRIC 13).

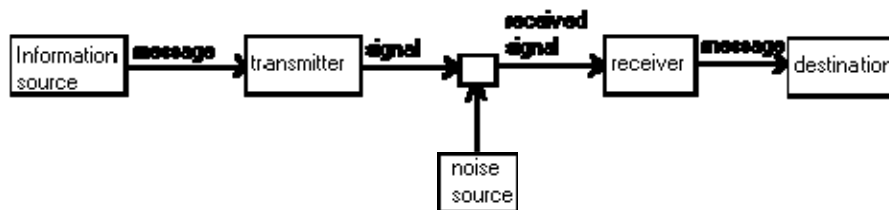


## 4. Theoretical framework

*In this chapter we will describe the chosen theories for this thesis. First we will describe communication theory in general and then its application to financial accounting. Then we will describe language theory, the information qualities of financial statements and different views of fair value.*

### 4.1 Communication Theory

There are many different definitions of communication. According to Larsson (2001) communication is the contact between people, while Gerbner (quoted in McQuail & Windahl 1993 p 4) gives the following example, “.....communication may be defined as social interaction through messages”. According to Fiske (1997), communication is the encoding and the decoding made by a sender and a receiver. The process is used to influence an individual’s behaviour and relates to questions such as efficiency and accuracy. One of the most important communication models originates from Shannon & Weaver. Their model sees communication as a simple, linear process. The model is applicable to different aspects of communication. (Fiske 1997)



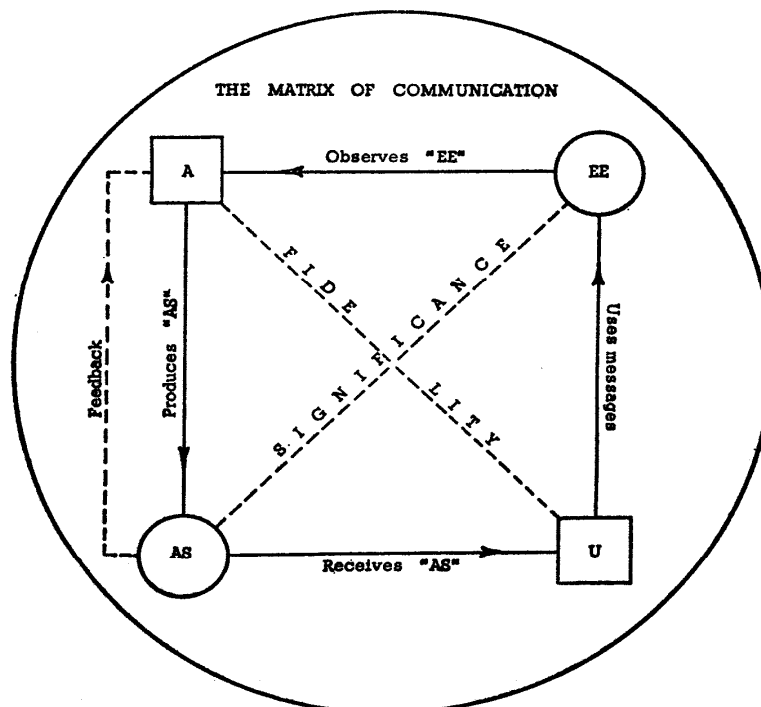
**Figure 1 The Shannon-Weaver Model (Shannon & Weaver 1947)**

When looking at Shannon and Weaver’s model the information source is the place where the information originates from, something that exists in reality. This can be for example an economic event. The transmitter is the one who encodes the information. This could be a person or a machine. The message sent will be reality as perceived by the transmitter. This will not be the same as the information source since it is not possible for the transmitter to perceive all the aspects of the information source (Fiske 1997). This is not possible since it is hard to produce a still picture of a dynamic economic activity. Korzybski said (quoted in Bedford and Beladouni 1962 p 655) “If we reflect upon our languages, we find that at best they must be considered only as maps”. Therefore the transmitter has to make some choices. If it is a machine the choices will be made by its construction but if it is a person it will be more complicated. The transmitter will send a message about the information source to the receiver and must encode it in order to send it. The transmitter will turn it into signals (a message) and use channels to send the message. The



receiver's perception of the message is not the same as the message encoded by the transmitter since it is not possible for the receiver to perceive all the aspects of the message. The receiver's decoding will be influenced by attitudes, level of knowledge, communication skills, social position and culture. The noise can be described as the factors interfering with a correct decoding of the message; these can be technical or semantic obstacles. The destination is the element that uses the decoded message for a purpose (ibid).

In communication theory used for accounting there are two dimensions: The observational dimension and the productional dimension. The observational dimension is related to the information received from the economic events. This dimension also includes the interpretation of the information and the accountant's selection of information communicated to the users. The productional dimension has to do with the accountant encoding the information selected from the economic events into a message and the transmission of the encoded message to the users. The observational dimension is important to consider so that the communication process will not be manipulated by the management in order to influence the users in a desired way (Bedford & Baladouni 1962). "If accounting data are to be used to interpret past performance and to predict future performance, the significance of such information becomes of primary importance" (Bedford & Baladouni 1962 p 652).



EE Economic Events of a Business Enterprise.  
A Accountant of a Business Enterprise.  
AS Accounting Statements of a Business Enterprise.  
U Users of Accounting Statements.

Figure 2 The Matrix of Communication (Bedford & Baladouni 1962)



There are four basic elements in figure 2. Circle EE represents the reality taking place, which corresponds to the economic events in the company's world. Square A stands for accountant and represents the accounting machinery and the auditors producing the accounting of the company. Circle AS stands for the company's accounting statements. Square U represents the ones that use the accounting statements in order to make decisions connected to the company. The accountant (A) observes the economic events (EE) and then selects the aspects of the economic events that are to be encoded into accounting statements (AS/message). The accounting statements (AS) are received and decoded by the user (U). The accounting statements will be used in the decision making. There is a possibility for the accountant to inspect the accounting statements after production and in that way create feedback before the statements are sent to the user (Bedford & Baladouni 1962). Instead of the term accounting statements we will use the term financial statements.

In The Matrix of Communication fidelity is the correspondence between the user's understandings of the financial statements and the expressed intention of the message. The communication of a message is perfect if the message is produced and interpreted by the user with a hundred percent fidelity. It is rare that a message has a hundred percent fidelity in encoding and decoding. Significance shows the degree of relevance and accuracy between the economic events and the financial statements. The significance is very important since the user's future activities are influenced by the financial statements (Bedford & Baladouni 1962).

When analysing the empirical material we have been influenced by the triangle between the economic events, the accountant, and the financial statements in The Matrix of Communication. The significance between the economic events and the financial statements has then been analysed. In our study the economic events have been compared to the customer loyalty programs and the accounting statements have been compared to the financial statements. The significance between the economic events and the accounting statements has been replaced by The Complexity-Consensus Model that will be explained later in this chapter. This model has been helpful when analyzing the information quality of the financial accounting. We will not consider the fidelity factor in The Matrix of Communication since this is not a part of our study.

## 4.2 Language theory

Language theory is one of many approaches in communication theory. Language theory is applied when encoding a message used for communication. Financial accounting is the encoding of messages while financial reporting is the communication process. Cherry (quoted by Salvary 2005 p 4) refers to language as a form that "emerges from the continual play of governing conditions or law". Financial accounting is a symbolic language, meaning that its purpose is to identify things, actions or relationships. It does not cause a reaction based on the way it was presented but on the facts indeed presented. The syntactic theory of language can be applied to accounting. (Salvary) Katz (quoted in Salvary 2005 p 6) claims "The primary consideration in deciding what sort of rules will appear in the syntactic component is the character of the sentence structure that these rules must describe". Examples on sentences of the accounting language are the balance sheet and the profit and loss account. The laws regulating financial accounting are



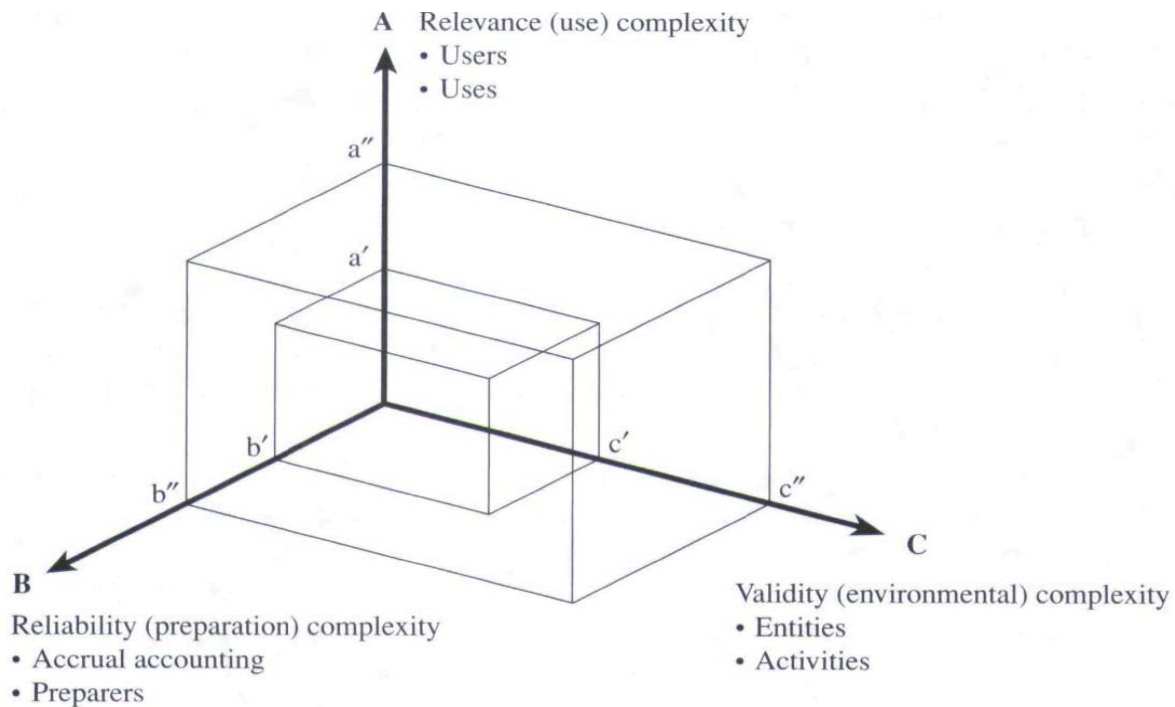
very basic and simple. The accountant should consider the regulations when encoding the complicated real economic events. The real economic events should be encoded into suitable accounting information that is possible to communicate (Salvary 2005). Mattessich (quoted in Salvary 2005 p 1) claims that “The *language* of accounting is comprehensive enough to warrant the transmission of information to a great many potential users. It is a language that-though it may change in dialect-is well proven....The chief problem is to find the golden middle between the quest for *simplicity* of language and *diversity* of its application”.

We have been influenced by language theory when analysing if and how the two regulations, IAS 18 and IFRIC 13, will render different degrees of complication in their way of depicting the economic events and the diversity of application.

### 4.3 Information quality

Gibbins & Loewen (2005) consider three different qualities of accounting information when looking at the complexity of how to obtain fairness. The three aspects they refer to are relevance, reliability and validity. The relevance of financial accounting means that the accounting information should be useful to its users. There are two elements that complicate the relevance, one is the variety of people that can use the accounting information and the other is that the information could be used for different purposes. The reliability of accounting information is related to how it is prepared. There should be as few flaws as possible in the financial statements. The reliability is affected by the judgements that have to be made in the accounting. The other factor that affects this refers to the ones that prepare the financial statements. They might have different incentives, expertise and judgements. The last quality is validity and this is the measure controlling if the financial statements represent the economic reality of the companies. Validity is sometimes labelled as representational faithfulness. (ibid) According to Solomons (1986) the representational faithfulness makes sure that the measure performed represents the phenomenon it was meant to measure. That is, that the measure should faithfully represent the phenomenon chosen to be measured. “Representational faithfulness is crucial to accounting’s ability to present a picture ‘of economic reality’ in an enterprise’s financial statements” (Solomons 1986 p 92). One of the factors affecting the validity has to do with the fact that there are many varieties of economic companies. The other factor relates to the differentiation of activities that can take place in a company (Gibbins & Loewen 2005).





**Figure 3 The Complexity-Consensus Model (Gibbins & Loewen 2005)**

In figure 3 we can see that there is a relationship between relevance, reliability and validity. The small box ( $a'$ ,  $b'$ ,  $c'$ ) in the figure shows that the three qualities when accounting is simple and not so complicated. Here the relevance, the reliability and the validity are easily obtained. If looking at the relevance of this condition there are few people using the accounting information and there are not many purposes that the information could be used for. The reliability is easy to obtain since there are strict laws that do not require judgements from the preparers. The strict laws also make sure that it is less likely for preparers to be influenced by different incentives, expertise and judgements. The validity would be easier to obtain in the small box since there are not so many different kinds of economic companies and the differentiation of activities in the companies is small. When the volume of the box increases it will be more difficult to achieve an accounting with appropriate relevance, reliability and validity. Then, there would be more complexity. There would be more users, more principles instead of rules, more judgements and more differentiation in companies and their activities (Gibbins & Loewen 2005).

In figure 3, the three qualities are drawn rectangular but they might just as well be correlated. A low validity could render a low reliability in the accounting, since the preparation of it could be unreliable. If we were to decrease the three factors at the same time, then we would have an economic world with a low differentiation of economic activities and there would be strict rules controlling the accounting. This would affect the allocation of resources and make it ineffective. If we were to increase the three factors at the same time, then the economic world would have a high differentiation of economic activities and the accounting would be based on principles. This will lead to a less reliable accounting since the preparers will have more choices and will have to use their judgement to a greater extent. There has to be a consensus between preparers and users,



defining when the relevance, the reliability and the validity are acceptable (ibid). According to Gibbins & Loewen (2005 p 272) fairness will be defined as "...an accounting solution where, at a given level of environmental complexity (dimension C), the preparers (B) and users (A) can reach the consensus that the solution is fair".

Relevance depends on whether the users can reach an agreement on what information is best suited for them. When there are a lot of users, and more will be added by time, this is a complex matter. Reliability is dependent on the ability of the preparers to agree on what accounting models to use. There could be different views among the preparers because they value relevance and reliability in various ways. Companies are becoming more complex and have to consider the most valid measurements between the fair value and the historical cost (Gibbins & Loewen 2005).

It has become attractive to use a more principles-based accounting instead of using a rules-based accounting. A lot of people are displeased with the rules-based accounting and would prefer to be able to use judgement to a greater extent. Standards based on rules "...may results in accounting that influences business rather than objectively reporting on them, and that meets the form of the rules but may miss the substance" (Gibbins & Loewen 2005 p 276). Rules reduce complexity since there are not so many solutions to choose between. The reduced complexity leads to that the box decreases and it will be easier to achieve fairness. However, decreasing the complexity leads to a lower validity since the economic reality is not well represented by rules-based accounting. If the users want to be able to compare the companies accounting, then they should be in favour of the rules-based accounting. On the other hand, if the users prefer accounting that can be used specifically for every company then they should be in favour of the principles-based accounting. If judgements can be proven to increase the validity more than they decrease the reliability, then the principles-based judgements would be proved to be better than the rules-based accounting (Gibbins & Loewen 2005).

Validity and reliability will affect the comparability of the companies' accounting (Solomons 1986). FASB's definition of comparability in accounting is "the quality of information that enables users to identify similarities and differences between two sets of economic phenomena" (Solomons 1986 p 102). The comparison could be between different years in a single company's accounting. Or it could be a comparison between the accounting of two or more companies. It is apparent that different inputs to the compared accounting will lead to a decrease in comparability. To regulate the accounting is one of the best methods for reaching comparability between companies. Data based on consistent inputs is not the only requirement to reach comparability, the data also has to be well chosen and complete (Solomons 1986).

We have been influenced by The Complexity-Consensus Model in our study when analysing the information quality of the financial statements arising from the way that companies account for customer loyalty programs today and after IFRIC 13. The term comparability also has been used when analysing the information quality. The relevance as defined in this model have not be analysed since our study has not considered the users' point of view.



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## 4.4 Fair value

Revenue is one of the most significant items in financial statements and has an important impact on decision-making amongst investors. At the same time revenue recognition is one of the most difficult issues to handle. There are two different paradigms in the financial statements that handle the recognition of revenue. Those are the balance sheet that gives information on the company's financial state and the profit and loss account that measures the company's performance. The balance sheet is also called the paradigm of the asset and liability view and the profit and loss account is also called the paradigm of the revenue and expense view (Wüstemann & Kierzek 2005).

In the paradigm of the revenue and expense view, the objective is to measure the company's performance. The indicator of the company's efficiency is the net periodic income. The principles mainly used are the realisation principle, the matching principle and the accrual principle. In this paradigm the purpose of the balance sheet is not to accurately show the financial state of the company but to accommodate remaining amounts arising from deferral. In the paradigm of the asset and liability view, the purpose is to show the company's financial state. The assets and liabilities show the company's wealth while the revenues and expenses can be indirectly determined. Principles that can be used when recognising changes in assets and liabilities are the realisation principle and the matching principle. Even though this paradigm is often related to the measurement of fair value, other measurement methods can also be used. The standards recently developed show that there is a trend towards using the paradigm of assets and liabilities. (ibid) According to Wüstemann & Kierzek "Both the relevance as well as the reliability of measuring performance obligations at fair value and of the consequential recognition of revenue at contract inception is questionable" (2005 p 85).

FASB (in Glover et al. 2005 p 267) concluded that "...fair values for financial assets and liabilities provide more relevant and understandable information than (historical) cost or cost – based measures". There has been much concern regarding the reliability in fair value. It is difficult to make a reliable judgement of the fair value. The least reliable estimates are the ones that have to be made with fair value when market prices are not available. (Glover et al.2005) According to Glover et al. (2005), all measurements of fair value are forecasts since the transaction has not yet taken place. Their conclusion is that relevance has been given more "importance" and this has affected the reliability in a negative way (Glover et al. 2005).

In "fair value accounting", Schmidt (2005) advises against the shift toward a higher use of fair value. Fair value is less reliable since there are not always a functioning market for the assets and liabilities valued. The estimates will be subjective, affecting the reliability. She believes that ".....additional types of disclosures should be considered to give users of financial statements a better understanding of the relative reliability of fair value estimates" (Schmidt 2005 p 28).



## 5. Empirical findings

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*This chapter includes two different parts in the empirical findings. The first part is the preliminary study that consists of the empirical data collected on the companies before the interviews. The second part shows the obtained research findings.*

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### 5.1 Preliminary study

This part includes facts and figures about the chosen companies and information about customer loyalty programs in general but also the chosen companies' customer loyalty programs.

#### 5.1.1 Facts and figures about the chosen companies

##### **ICA**

The ICA Group (ICA) is a leading retail company in the Nordic region with about 2 300 owned and retailer-owned stores in Sweden, Norway and the Baltic States. The group consists of ICA Sverige AB, ICA Norge AS, Rimi Baltic AB and ICA Banken AB. The ICA Group's turnover in 2006 was 67 395 million Swedish crowns and the result was 2 297 million Swedish crowns. The total number of employees is 11 698 (the employees in the retail-owned stores are not included). Ica is owned by Royal Ahold (60 percent) and Hakon Invest AB (public, 40 percent).

##### **Lindex**

The Lindex group (Lindex) is a leading fashion chain in northern Europe and owns about 350 stores in Sweden, Norway, Finland, Germany, Estonia, Latvia, Lithuania and the Czech Republic. Lindex's turnover in 2006/2007 was just about 5 000 million Swedish crowns, tax included and the results totaled almost 303 million Swedish crowns. In 2007 approximately 5 000 people worked for the Lindex group.

##### **SJ**

Statens Järnvägar (SJ) is owned by the Swedish state and the company's share of the market on train travelling longer than 10 kilometres is 90 percent. SJ's trains depart from 200 places and the company has approximately 3 581 employees. In 2006 SJ's net turnover was 6 900 million Swedish crowns and the result amounted to 368 million Swedish crowns.

#### **The airline industry**

##### **Finnair**

Finnair is the market leader within flying traffic to and from Finland and gateway traffic via Finland. In 2006 the turnover was 1 990 million Euro and profit before taxes minus 15 million



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Euro<sup>1</sup>. The approximate number of employees is 9 598 people. The biggest owner is the Finnish state.

### **British Airways**

British Airways is one of the largest international airline companies in the world and the largest international scheduled airline company in the UK. In 2006/2007 the revenues amounted to £ 8 492 million and profit before taxes to £ 611 million<sup>2</sup>.

### **South African Airway**

South African Airway (SAA) is the first and leading airline in South Africa. Close to 10 000 people are employed in the company that flies to over 700 destinations all over the world. The turnover for 2006/2007 was 17 021 million R (South African Rand) and net profit was minus 883 million R<sup>3</sup>.

## **5.1.2 Customer loyalty programs**

Several studies have been made on customer loyalty and its definition varies (Söderlund 2003). In this paper we have chosen to use the definition made by Holmberg, that customer loyalty is when a customer “has a tendency to continue to shop in a certain store or buy a special brand” (2004 p 8). Customer loyalty is something that usually lasts for a long time and it cannot be forced, there needs to be some freedom of choice. The customer needs to be able to choose and to have some alternatives. Loyalty is not possible if the customer can not be disloyal (Holmberg 2004). Customer loyalty programs are a way to build a market that in the long run will generate profitable customers. These customers are described by Elinder (1993) as frequent buyers that buy more every time and stay loyal for a long time. The main purpose of customer loyalty programs is to retain and develop these characteristics to a lower cost than alternative marketing measures (Elinder 1993).

One model commonly used for crediting loyal customers is known as the promotional currency approach. When the customer spends money he or she earns a promotional currency defined as miles or points which can be redeemed for something of value, for example free travel (Duffy 1998). The bonus is a way to motivate the customer, but also a price for receiving marketing information about the customer (Elinder 1993).

In 1978 the American congress passed the Airline Deregulation Act. Until then domestic air service and marketing had been under federal control. From that point on, it was the market that determined the fares and the levels of service. Due to the deregulation the airline industry struggled with differentiation because in most cases prices and services among the companies were equal. In 1981 American Airlines introduced, as a solution to the differentiation problem, a customer loyalty program called AAdvantage. This frequent flyer program offered loyal customers free travel. Shortly afterwards, United Airlines also introduced a customer loyalty

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<sup>1</sup> 100 Euro 2006-12-29 = 11,0497 SEK (www.valuta.se)

<sup>2</sup> £ 100 2007-03-30 = 7,2900 SEK (www.valuta.se)

<sup>3</sup> 100 R 2007-09-28 = 106,3830 SEK (www.valuta.se)



program called Mileage Plus program. Soon after this introduction every company in this industry had or participated in one or more customer loyalty programs. These programs, which started with an offer of “fly with us and eventually fly free” (Duffy 1998 p 438), are today much more sophisticated and have spread over the world. Travellers earn miles not only when flying with the airline company but also when using other products and services from entities in collaboration with the airline company, for example hotels, car rental companies and credit card companies (Duffy 1998). The award credits can be redeemed when the customer has collected the amount required to redeem the sought award. The award credits/miles are based on flown kilometres and type of booking class.

In Sweden the petrol companies were the first to have customer loyalty programs and offered special customer cards. They were followed by the banks that collaborated with some lines of business within retail trade, such as radio and television (Gothnier 1999). Customer loyalty programs are today a common phenomenon and almost every store offers some kind of membership which gives the customers some kind of discount or bonus. A survey made by Carat Insight shows that 85 % of the Swedish population, between the ages of 20 and 60 has a bonus card in their wallet (Willhammar 2007).

ICA introduced their customer loyalty program in 1990 called ICA Kundkort. A member of ICA Kundkort collects award credits in each ICA-shop, staffed Statoil retailers and ICA Express-shops. To buy goods supplied by Systembolaget, Apoteksbolaget and mail order companies does not entitle the customer to award credits. This also applies to lotteries, tickets and so on. One award credit is obtained by each payed Swedish crown. If the membership is ICA Bankkort Plus the member can also collect award credits at different companies attached to Mastercard in Sweden and abroad. A membership in ICA Bankkort Plus entitles the customer to 0,5 award credit for each Swedish crown. The bonus checks received can be redeemed only at ICA-shops and cannot be redeemed for cash. The member receives a bonus check for 25 Swedish crowns for every 2 500 award credits collected. The check is handed out with the next monthly member letter after the collected awards have reached the amount of 2 500. The bonus check is valid for six months. The amount paid with the bonus checks does not render award credits. If the member has not collected 1 000 award credits per month during the last six years the already collected points will fall due. The member is able to start collecting award credits the following month. ICA has the right to close a member’s ICA Bonus if he or she has not collected any award credits in five years. ICA Kundkort has about 3,1 million members today.

Lindex introduced their customer loyalty program with bonus points in 1995. At Lindex the customer has the possibility of using a member card with or without credit. Members are able to collect award credits only if they use a credit card to pay for the goods. This credit card is administrated by IKANO Banken AB. The customer receives two credit awards for each Swedish crown. When 2 500 credit awards are reached the customer will receive a bonus check of 25 Swedish crowns. Lindex will send bonus checks four times a year with the invoice accrued by the goods bought. If the customer is not able to reach 2 500 award credits in 24 months the already collected award credits will fall due.

SJ introduced their customer loyalty program with bonus points, called SJ Prio, in May 2007. There are three different memberships at SJ, one is base level (white) and the others are privilege



level (grey and black). Award credits are collected when buying services and goods at SJ and at special occasions from third parties. It is not possible to collect award credits for a co-traveller or when buying tickets onboard the train. As a member you collect the award credits even if someone else is paying for the services and goods. The member can also be collecting "Remaining award credits". Those are handed out at campaigns or from third parties and does not affect the member level. The member level depends on how many award credits the member has collected the past year. The different levels render different privileges. Award credits are not handed out when using the points, for example at travels paid by award credits. The member receives one award credit per Swedish crown. The award credits can be redeemed for travels, certain goods in the bistro or other temporary offers made by SJ or a third party. Not all travels are available when redeeming the award credits. The validation for the award credits is limited to the year in which they are collected and two years forward, falling due on December 31 of the last year. Today SJ has about 100 000 members.

## 5.2 Research findings

This part includes a presentation of the respondents followed by the answers given at the interviews. The answers also include the airline industry in which case information is collected from comment letters that IFRIC received regarding the draft interpretation.

### Presentation of respondents

#### **Gustav Nygren - ICA**

Nygren works as an IFRS manager/accounting specialist at ICA in Stockholm. He has worked with this since August 2006. After graduation from Örebro University he started as a trainee at KF now called Coop and worked for them for eleven years. In 2001 he started working as an IT/Computer consultant and before starting at ICA he worked at KPMG for four years. Nygren works with different kinds of accounting questions and has several areas of responsibility. He is for example in charge of making ICA's handbook for accounting that describes how the company should account according to IFRS.

#### **Helena Tjärnström - SJ**

Tjärnström works as an accounting manager and she has worked in this position for one year. She is responsible for the consolidation of the companies' accounts and also for all reporting regarding interim reports and the accounting part of the annual report.

#### **Emma Pettersson - Lindex**

Pettersson works as financial manager and has worked at Lindex for three and a half years. The first six months she worked with Lindex consolidated accounts and after that as a financial manager. She is responsible for the annual accounts, the consolidation process, the juridical structure and juridical questions and several other economical and financial questions.



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### **Pär Falkman - Ernst & Young**

Falkman works as an accounting specialist and has worked at Ernst & Young for seven years. Before that, he worked for the finance department for 3 years and at the School of business economics and law, Göteborg University. His main tasks are to support by making surveys and by answering answer to accounting questions from listed companies, smaller companies and municipalities. Falkman also works as an educator within the bureau, mainly educating about IFRS.

### **Jan Hanner - Öhrlings Pricewaterhouse Coopers**

Hanner works as an accounting specialist and his task is to answer complex accounting questions from both clients and auditors.

## **The main reasons for the companies having customer loyalty programs**

For ICA, Nygren says, the customer loyalty program is a way to stimulate customers to be loyal to ICA instead of shopping at for example Coop. He says the programmes are very important and that the company never could remove this kind of incentive. That would be seen as something very negative. Because of the competition they need to have it since almost every has a customer loyalty program nowadays.

SJ started their customer loyalty program this year because, as Tjärnström explains it, they wanted to understand their customers, to see how they travel and what they demand. It is also a way to create loyalty. It is difficult to say at this stage how important SJ Prio will be.

For Lindex, Pettersson says, the customer loyalty program is a way to learn more about the customers and to offer loyal customers something extra. The customer loyalty program is an important part but how important is hard to tell.

For the airline industry the main purposes for customer loyalty programs are to create loyalty among their customers with incentives to buy products and services, to collect information, and to identify the most frequent flyers. It is a marketing tool ([www.iasb.org](http://www.iasb.org), comments, CL20, 22, 35).

## **The regulation chosen by the companies when accounting for customer loyalty programs today.**

ICA has chosen to account for their customer loyalty program according to paragraph 19. For example if ICA sells goods for 100 crowns the customer redeems 1 award credit. In practice 100 crowns are therefore coded as liquid capital in debit and as revenue in credit. The award credit is seen as a commitment in the future and it should therefore be coded as a liability but the award credit is also seen as a cost which should affect the result. 1 crown is debited costs and 1 crown is credited liabilities. When the customer uses the award credit 1 crown is coded as cost in credit and liability in debit. The cost in this case, 1 crown, has to match the expected compensation or discount ICA will give in the future. When this cost is being calculated, ICA also includes the





probability of the amount of award credits that will be used. It is ICA Banken that works out this data and the probability rate is between 3 and 5 percent. Nygren says that it is more probable that it is the lower limit than the upper one since many customers use their award credits. This is based on historical data which is followed up every month. He describes that these data vary little over time and are precise. In the case of the example mentioned above the cost will therefore be decreased with the probability rate and will end up at about 0,95 to 0,97 crowns. Nygren has no answer to why ICA has chosen to account in this way but he says that this way feels more natural. When he worked for KF (Coop) they made the accounting in a similar way. He says that the discussions they had was whether this is an essential post or not. ICA has come to the conclusion that this is not an essential post and therefore it should not affect the turnover.

Tjärnström explains that SJ sees the award credits as a cost in the future just as ICA does. This future cost is coded as a marketing cost in debit and as a liability in credit. When the award credits are being used liabilities is set off against other revenues. The calculation of the marketing cost is based on the cost for one person to travel from for example Stockholm to Göteborg. This cost is not based on the total cost because it will not change if one additional person travels on the train. Costs for staff and electricity are therefore not included. Since they do not have any direct marginal cost they have calculated the cost based on what an additional railway carriage with travellers would cost. When marketing cost is calculated the company has also considered the probability that the customer will use these award credits and what they will buy. SJ has a large model for calculating this. The customers have a lot of options when redeeming their award credits, such as tickets, internet, food and beverages from the Bistro and event tickets. As mentioned before SJ's customer loyalty program was introduced this year and therefore Tjärnström participated in the discussion of how to account for their customer loyalty program. They looked at other companies and industries for guidance, for example at the airline industry. The reasons for choosing this model was that it seemed as if it was the most commonly used model and that they did not know how much the program would affect the revenues. It seemed a little dangerous to affect the turnover a lot because several key figures would change and therefore it seemed better to account the award credits as a marketing cost instead of adjusting the revenues. When they started with this program they did not know how well it would turn out and what the outcome would be. If they had chosen the other method and people collected award credits but never used those, then the result would seem more uncontrollable because a large amount would decrease the revenues. When looking back she says that it would not have mattered which way they had chosen to account, because the award credits are a very small part of their total turnover.

Lindex accounts their customer loyalty program according to paragraph 13. Pettersson explains that the companies can see the award credits as a marketing cost or as a discount. Lindex has chosen the latter one and therefore the accounting of the award credits affects the gross margin instead of operating costs. The liability is measured in relation to the costs of the award credits multiplied with the rate of probability that the award credits will be redeemed in the future. The probability is based on experience and sales statistics (Lindex annual report 2006-2007).

Pettersson explains that when preparing the annual account they look at how much of their sales resulted in award credits. After that they make certain assumptions about how many of the award credits will be redeemed in the future, adding a margin. Lindex has accounted for their customer



loyalty program in this way for a couple of years and Pettersson believes that it is important to have the right cost in the right period. It is also important to realise that the award credits are a commitment that should be accounted for.

The airline industry, Finnair, SAA, and British airways, all account for customer loyalty programs with a cost approach. The cost is based on the marginal cost and is seen as a marketing expense. The reason for this method is the way that they grant points/miles per flown kilometres/miles, meaning that the value of the point/mile is not calculable from the sales transaction. (www.iasb.org, Comments, CL 20, 22, 35). The value of the trip redeemed is insignificant since the customer has a limited choice of awards. If the trip is divided between different airlines their revenue is based on the value of the ticket and flown kilometres by the airlines. The customer will receive the award credits from the airline whose customer loyalty program they belong to. This airline will invoice the other participating airlines for the award credits belonging to their flown kilometres (ibid).

According to Falkman companies account for customer loyalty programs in the same way that they have always done. For example, if I buy a ticket at SAS today, then the total value of that ticket is for the trip bought today. It does not matter that I receive bonus points that I can use for buying a ticket in the future, the trip is still the total value of the purchase. These award credits are given a value and for every sold ticket SAS is building up a commitment in the future to provide these “free trips”. But in the perspective of the companies these systems are costly and therefore they are accounted as a cost. The reason for accounting in this way is not based on principles but on praxis. What the old praxis is built upon is hard to say. Falkman argues that if you buy something for 1 000 crowns that is accounted for as revenue but the company owes you something in the future, the question raised is: what does the company owe you? If it is not revenue it has to be a cost.

### **IFRIC 13's affect on the companies way of accounting**

Nygren says that the changes at ICA will be that instead of accounting for a cost at the customer's purchase they need to reduce the revenues with the amount of award credits that will be redeemed. The amount that represents the award credits will be accounted for as prepaid revenue instead of as a liability. When the award credits are redeemed the revenues will increase and the prepaid revenues will decrease. There will be a difference in the profit and loss account and another characterisation in the company's balance sheet. Practically, they have to look over their systems handling the information flow between ICA Banken and the ICA dealers. It is ICA Banken who is in charge of this system and during 2008 the changes that need to be done will take place so that it will be applicable in 2009.

Tjärnström says that instead of accounting for a marketing cost they will account for a decrease in revenues. She points out that if all award credits will be collected and redeemed in the same year, then there will be no effect. If this is not the case, then revenues will decrease. In the long run this will not affect SJ because the amount that we are talking about is so small compared to the total amount of revenues.



As mentioned before, Lindex has been bought up after performing the interview and they are now working with a harmonization of the accounting. It is therefore at present, difficult for them to state how IFRIC 13 will affect their accounting.

A problem raised by SAA is that they will have an overstated liability for the deferred revenue that does not give a correct image of the company's financial state (www.iasb.org, Comments, CL22). What is known in the case of Finnair is that the airline's system of customer loyalty programs and revenue accounting systems are not integrated. If the member enters the customer number when paying for the ticket it will be connected with the revenue accounting system. If the member does not do this until check in or after the trip there will be no connection between the two systems. Due to this, the implementation of IFRIC 13 will lead to high costs for the airline industry (www.iasb.org, Comments, CL20).

According to Falkman the reason for implementing IFRIC 13 is that IASB and IFRIC want to switch focus within accounting from costs to revenues. They want to separate the different parts within revenues and not just sum it all up and correct it afterwards as a guarantee of commitment. They want to affect the turnover because, according to them, it is now overvalued. He is not sure, but he believes that the situation arises from the fact that cost accounting is difficult to justify in principle. It is easier to justify the theory behind the method advocated by IFRIC 13 because the other method is based on old praxis. Falkman thinks that with IFRIC 13, IASB has chosen, theoretically speaking, a very brave method in changing focus from revenues and expenses to assets and liabilities. With IFRIC 13 the companies will need another way of thinking. Falkman means that the companies have to rethink the value of the purchase that includes award credits. IFRIC and IASB are shifting the focus within accounting and are now leaning towards that revenue should be accounted for separately. As described before, if you buy an airplane ticket, IASB believes that you are buying two things, one ticket for today but also a part of a ticket for the future. The airline does not give out tickets for free, there is a value in the award credits. The difficult part is to value the award credits. From an accounting perspective it is theoretically excellent but the question is if it is practically applicable. Here the revision must control that the value is not underestimated. But the companies have to make a judgement even today; they cannot just take an amount and account for it as a liability. The most significant changes, in the figures with IFRIC 13, will be that the turnover will initially be lower due to the overvaluation of today's account and instead of accounting the award credits as a liability it will be accounted for as revenue paid for in advance. The result will be almost the same using the two methods. In the year of implementation, interested parties will notice a change and there has to be an explanation in the annual reports.

Hanner says that in theory IFRIC 13 is correct but he thinks that it will be difficult to implement for the companies. Revenue accounting is the most difficult part in the field. Questions from companies about when they should account for revenues are the most difficult ones. This new approach by IFRIC makes heavy demands on accountants to really do their homework and make this allocation in an intelligent way. He does not think that this can be followed on a daily basis for example regarding the accounting of the day's takings. "Should they just account for 99,9 %?" It is not practical to do so, he says. What they will probably do is to account for the total amount of the day's taking as sales revenue and then later correct their commitment. This would probably take place when the companies are giving out their quarterly and annual reports.



Reasonably thinking they would have to decide within the company how much the revenue from the customer loyalty program affects the turnover and ask themselves what precision they need. The companies must have good statistics and Hanner thinks that they have that today already. In time he is convinced that they will get a feeling regarding the frequency. IFRS says that it is important to apply the regulations on essential items. Hanner cannot estimate how essential revenues regarding customer loyalty programs are. If the item is considered unessential the companies do not state in their annual reports that they do not follow the regulation. Instead they follow the principles estimating calculations. Hanner says that IFRS wants companies to discuss difficult accounting questions and if the company thinks that an item is essential in the balance sheet but has difficulties with for example valuation, they can explain this with verbal text and explanations. In this section they can describe alternatives, the reasons behind the choice they have made, and make some kind of sensitivity analysis regarding the consequences if every company accounted in this way. But on the other hand Hanner does not believe that customer loyalty programs are an essential part of the balance sheet in these companies but “I may be wrong”, he admits.

### **The affect on the information quality of the accounting when using the fair value on the award credits according to IFRIC 13**

Nygren believes that with the fair value the debt will be bigger but there will be so small differences that it will not be noticed. They have discussed the fair value and the question concerns the definition of fair value. Is it the fair value considering the perspective of the customer or is it considering the perspective of the collective, in this case ICA's? From the perspective of the customer it is very simple. He or she receives a check at 25 crowns and that is the fair value. But the fair value from ICA's perspective is more difficult. If someone would like to buy this debt they would not pay 25 crowns because they know that the redemption degree is not 100%. Therefore it is not the customers' fair value we should account for but instead the collective's fair value. I think that fair value is often diffusely defined in several standards, Nygren says.

Tjärnström says that this will lead to changes. “Now we are calculating on a marginal cost and that is lower than the fair value”. The disadvantage with this is that it will “disturb” the normal accounting more than the matching principles due to the accounting of the value for the customer instead of the estimated cost for the company. However, as mentioned before, they believe that the effects arising with IFRIC 13 will not be essential since the value of the award credits will be a small part of their total revenues.

As mentioned before, Lindex has after performing the interview been bought up and are now working with a harmonization of the accounting. It is therefore at this status difficult for them to state how the fair value of IFRIC 13 will affect their accounting.

In the airline industry the accounting of the fair value is a bigger problem. The market price varies depending on several factors such as the time of booking, route, time of day, cabin and flexibility to make changes. Therefore the reservation system has, for each route, numerous different prices. The ticket prices may vary a lot but the points/miles granted are always based on distance. IFRIC 13 will lead to a complexity and variation in accounting across the industry



(www.iasb.org, CL 20, 22, 35). In industries with fixed prices such as manufactured products there will be no problem with the fair value but in the airline industry pricing is dynamic and is “driven by the specific nature of airline inventory – there is only one opportunity to sell an airline seat” (www.iasb.org, CL 35 p 1). Because of the dynamic pricing the alternative value of a seat is low. If the seat will not be taken by award credits customers, then the seat might not be sold. The award tickets are from the lowest availability rate in the booking class hierarchy and the customers are not given the possibility to choose freely and therefore will not be able to redeem the rewards whenever he or she wants. An ordinary purchased flight ticket and an award ticket is not comparable (www.iasb.org, CL 20, 22, 35).

Falkman says that the companies need to agree on the meaning of fair value because it will be really difficult to change to an accounting where revenues are not based on some kind of invoice. That would lead to a very subjective form of accounting. He does not know how the companies are supposed to measure what the customer is willing to pay for goods or services.

Hanner says that it will probably be difficult for the airline industry because of the difficulty to estimate the value of a ticket. Should it be based on last minute price or another price?



## 6. Results and analysis

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*In this chapter we will state the results of our study and analyse the collected empirical material with the chosen theory as an influence. To reach the purpose of the study we will first apply the empirical material to selected parts of Bedford and Baladouni's model, The Matrix of Communication. We will also apply language theory when analysing the first part in The Matrix of Communication. Finally we will, with influence from the Complexity-Consensus Model, analyse the effects on the information quality.*

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### 6.1 The Matrix of Communication

By using Bedford and Baladouni's model we will apply and analyse the empirical material starting with the observation of the economic events made by the accountant. Thereafter we will analyse the process of producing the financial statements. Since we have come to the conclusion that the companies studied use both the cost approach method and the deferred revenue method of IAS 18, both methods have been compared to IFRIC 13 when analysing the effects on the information quality of the accounting.

#### 6.1.1 From economic events to accountant

In order to be able to analyse the effects that IFRIC 13 will have on the information quality of the companies' accounting we have to consider the complexity in the depiction of the economic events. We are influenced by the relation between the Economic Events and the Accountant in The Matrix of Communication when considering this. When looking at the complexity of depicting economic events through language theory the quest is to find a balance between a simple way of depicting the economic events while at the same time relating a diversity of applications (Salavary 2005). The rules of IAS 18, when using the cost approach, are very basic and simple. Following these rules is not so complicated according to the companies. They still have to make estimations when determining the redemption degree of the award credits. The rules of IFRIC 13 are more detailed and more complicated. The language of IFRIC 13 is less simple and will have less diversity of application. This should make the implementation of the rules more difficult, affecting the information quality of the accounting. However, IFRIC 13 should render a better depiction of the economic events since the deferred revenue approach and the fair value will be used. Since IFRIC 13 will be more detailed, more rules-based, there will be less different solutions to choose between in the accounting. This should make it less possible for the accountants to be subjective. This will be discussed further later on in this chapter.

Implementing the communication theory, it is impossible for the companies to have all the information necessary to make a perfect depiction of the transactions of the customer loyalty programs. The redemption degree of the award credits is based on the past but it is still not a perfect picture of the economic reality. The companies will have to make estimations when allocating revenue to the award credits. The same estimations will also have to be made when using the cost approach. However, when following IFRIC 13 the companies also have to consider the use of fair value. It is sometimes very easy to establish the fair value; this is the case for some of the companies that we have studied. However, there are some companies that have to make further estimates when implementing the use of fair value. For some of the products or services there is no obvious fair value or the fair value is not applicable. The accounting specialists question whether IFRIC 13 is practically applicable when it is difficult to value the award credits. This will be discussed further later on in this chapter.

When interviewing the three companies we have noticed that certain aspects of customer loyalty programs are seen in different ways. The companies have different views when looking at the nature of the award credits. It is quite obvious that the different views would render different ways of accounting. The two approaches available in IAS 18 are two different ways of depicting the economic world.

### **6.1.2 From accountant to accounting statements**

ICA and SJ have chosen to depict the customer loyalty programs according to the cost approach. The reason for this is because they see the award credits as marketing costs. Within ICA there was not really a discussion about another choice. It seems more natural for them to account in this way, and their experience is that most companies do so. Within SJ there was a discussion, but the anxiety of affecting the balance sheet was obvious so the company decided on the cost approach. All of the companies agree that the award credits are not an essential post and Tjärnström therefore believes that it should not affect the balance sheet. The experience of the accounting specialists is that the cost approach is the most common way of accounting for customer loyalty programs. Lindex sees the award credits as a discount on revenues and therefore uses the deferred revenue approach of paragraph 13, IAS 18, when accounting for customer loyalty programs. For them it is obvious that the award credits are a commitment and should be accounted for accordingly. When studying the accounting method of the airline industry we have established that they use the cost approach. The reason for this is the complicated economic events taking place in the economic reality. Their way of allocating award credits per flown kilometres makes it impossible to calculate the value of the award credits based on the sales transaction. It would be too complicated for the airline industry to account according to the deferred revenue approach. The companies interviewed do not see the application of IFRIC 13 as a big problem. According to Falkman, the two accounting methods will render almost the same result. The effects will be more thoroughgoing and might be noticeable the first year of implementation.

With IFRIC 13 the accountants of the chosen companies have to encode the economic events into financial statements considering new regulations. The main difference is that instead of



accounting the liability as a cost or a discount, they have to decrease the revenues as prepaid revenue. This is a new way of thinking, from seeing customer loyalty programs as a marketing tool to a way of deferring revenues. The companies have to see the first purchase a customer makes as something that includes two parts. One part consisting of the purchase made today and the other a part of something that will be purchased in the future. The companies interviewed do not believe that the implementation of IFRIC 13 will be costly or more time-consuming. It is mainly the airline industry that finds the application complicated. However, this could be an argument that might be used by them in order to try to stop the application since the costs for them in the beginning will be quite large. According to IFRIC, the estimations needed when allocating the amount of revenue to the awards credits will be needed also when estimating the cost of fulfilling the obligation. The major effects for the companies will be the estimations of the fair value that are to be allocated to the award credits, which might be complicated enough for the airline industry. Hanner believes that if the rules are too complicated, the companies might not bother to follow them. If they consider the award credits unessential, as do the three companies interviewed, they might estimate calculations.

As mentioned before, the financial statements regarding the recognition of revenue can be divided into two different paradigms, the balance sheet and the profit and loss account (Wüstemann & Kierzek 2005). The development of IFRIC 13 is a step from a paradigm of revenue and expense to a paradigm of assets and liabilities because of the way of accounting by the fair value. The use of fair value for the award credits is the aspect that for some companies will be the most complicated task when implementing IFRIC 13. For ICA and Lindex this will not be a problem since the value of the award credits is the same as the fair value of the products or services that will be redeemed. If we consider ICA's award credits of 25 Swedish crowns the fair value is 25 Swedish crowns. This is the fair value of the groceries received when redeeming the award credits of 25 Swedish crowns. The same goes for Lindex. The fair value is more complicated for SJ and the airline industry. When collecting award credits at SJ, the fair value for these are, according to IFRIC 13, the value that a customer would pay for the redeemed products or services. Falkman believes that it will be difficult for the companies to measure what the customer is willing to pay for a product or service. It is complicated to estimate the fair value of a train ticket since it has different prices depending on when the trip is booked. Which price is to be considered? This is a question raised by Falkman when discussing the complexity within the airline industry. For the airline industry the market prices vary depending on the time of booking route, time of day, cabin and flexibility to change. Since the seat probably would not have been sold if it would not have been taken by the award credit customer it is hard to define its relative value. If it would not have been sold the value would have been zero. However, if the seat would have been sold it would have been worth a great deal more than zero. Another complication for the airline industry is that the customers have a limited choice of trips and booking classes when redeeming their award credits. The airline industry therefore cannot see the comparability between an ordinary trip and a trip paid for with award credits.

According to Falkman the companies will have to decide on the meaning of fair value. It will be complicated for the companies to change to an accounting where the transactions are not based on some kind of invoice. This could lead to a great deal of subjectivity. Nygren thinks that it is difficult to define the meaning of fair value. According to him, the definition of fair value in IFRIC 13 is poor. The question arising is if it should be the fair value from the perspective of the





customers or the collective. If it should be the perspective of the collective, then the fair value would not be the 25 Swedish crowns since the redemption degree is not 100%. This shows that only the interpretation of IFRIC 13 is complicated enough for the companies. It is quite obvious that the companies will interpret the rules differently. We agree with Falkman when he says that the companies need to come to an agreement about the fair value. This has to be done in order to reduce complexity and variation in accounting throughout the industry when IFRIC 13 is being used.

## 6.2 The Complexity-Consensus Model

We will apply selected parts of the Complexity-Consensus Model when analysing the information quality of the companies' accounting, comparing today's accounting with the future requirements of IFRIC 13. We will also analyse the effects on the comparability arising with the implementation of IFRIC 13.

### 6.2.1 Validity

Validity is the quality of accounting information that measures if the financial statements represent the economic reality of the company. Validity is affected by the many varieties of economic companies and the differentiation of activities that can take place in a company (Gibbins & Loewen 2005).

Today, all of the studied companies, except Lindex, account for their customer loyalty programs according to the cost approach. IFRIC 13 requires a separation between the different parts of the revenue from the purchase. Today, the companies account for their profit before they perform the service or deliver the goods. The performance takes place in the future, which is to sell an additional service or goods. Instead of decreasing the revenues they increase the cost and the result remains the same. This leads to overvalued turnovers for the companies. Lindex reduces the revenues but not as much as will be required with IFRIC 13, due to the use of the fair value. With IFRIC 13 the companies will have a lower turnover which better represents the economic reality of the companies. IFRIC 13 will in this perspective increase the validity on three of the companies' accounting. The validity of Lindex's accounting will be unaffected.

Another factor affecting the validity of the accounting is the use of fair value. Today, all of the companies base their award credits on the cost of the goods or services that are to be redeemed in the future. When implementing IFRIC 13 they will be required to use the fair value of the goods or services that are to be redeemed. According to FASB (Solomons 1986) the fair value is a better depiction of the economic reality than historical cost. Consequently, IFRIC 13 will affect the validity of the companies accounting positively. From this point of view, the companies studied will have an increase of validity in their accounting. Since Lindex's accounting only will be affected by the use of the fair value, their current turnover is overvalued, but less overvalued compared to the other companies studied. According to the companies interviewed the value of the revenues belonging to the award credits are a small part of the total revenues and therefore the



effects on the companies are not essential.

IFRIC 13 is more rules-based than IAS 18. From this point of view, IFRIC 13 compared to IAS 18, will decrease the validity of the accounting. The reason for this is that the economic events in the financial statements are better pictured since IAS 18 is more diversely applicable and the companies can form the accounting according to their specific economic events. The question is which regulation will render the highest validity.

### 6.2.2 Reliability

The reliability of accounting information is related to the preparation. There should be a few flaws as possible in the financial statements. Reliability is affected negatively when more judgements have to be made in the accounting and when the preparers of the financial statements have different incentives, expertise, and judgements (Gibbins & Loewen 2005).

Today the companies are accounting for their customer loyalty programs based on the cost of the goods and services that are to be redeemed. The cost can in most cases be estimated in a reliable way because the companies base their calculations on invoices. The calculations are more reliable when based on historical cost and not on a forecast, that has not yet taken place. When determining the amount of the liability the estimations are not all based on facts but also on judgements. This is something that affects the reliability negatively. An estimation that includes judgements is for example the probability rate of the bonus points being redeemed. This will also be the case with IFRIC 13 so this is not a new phenomenon for the companies. Therefore the reliability will not be affected from this point of view.

When implementing IFRIC 13, and with this the use of fair value, it will be complicated for the companies to estimate the revenue of the award credits since they belong to a purchase in the future. This is not a problem for ICA and Lindex since no further judgements will have to be made when implementing IFRIC 13. Therefore, the fair value will not affect the reliability of their accounting. For SJ and the airline industry IFRIC 13 will affect reliability negatively because of the difficulty to calculate the fair value of the award credits in these companies. When the regulation of the financial statements leads towards a regulation, based on the balance sheet paradigm, reliability can be questioned. The reason for this is the use of fair value. The choice of focusing financial statements towards the balance sheet is a way of increasing the validity at the expense of the reliability (Wüstemann & Kierzek 2005). We agree with Schmidt (2005) when she declares that the fair value is less reliable when there is not a functioning market for the assets and liabilities valued. The reliability will decrease because the valuations can be subjective. Glover et al (2005) are also concerned with the fair value's negative influence on reliability due to the fact that the estimations are based on forecasts. When determining the fair value in the case of SJ and the airline industry the question is whether the bonus trip should be valued as an ordinary ticket or as a discount ticket? For higher reliability the preparers need some kind of agreement on how to estimate the value of the deferred revenue. If the preparers have different incentives, expertise and judgements then the outcome will differ, which will render a lower reliability.



Since IFRIC 13 requires judgements to be made the preparers that have incentives to account in certain ways will have greater opportunities. If for example an accountant has an incentive to increase revenue, then it is possible for him or her to affect the revenues in the wanted direction. If the expertise varies among the preparers, then the accounting will differ and reliability will decrease. Reliability is also affected by the interpretation of IFRIC 13. Our experience is that the rules of IFRIC 13 are complicated and some issues are poorly defined. The accounting will not be reliable if the implementation of IFRIC 13 will be diverse.

IFRIC 13 is more rules-based than IAS 18 which according to Gibbins & Loewen (2005) reduces complexity and meaning that there are not so many solutions to choose between which leads to a higher reliability. Comparing IFRIC 13 with IAS 18, which is more principles-based, the reliability is higher due to fewer possibilities for subjective judgements.

As several of our respondents have mentioned before, the amount involved in customer loyalty programs are very small compared to the total turnover. Such small amounts will not make a difference if the accountant chooses to account in one way or another. Their conclusion is that the reliability will neither be higher nor lower with IFRIC 13. Our belief is that even though the value of the award credits is low there will be effects on the information quality. The effects will be small for the companies interviewed but for companies with award credits of larger value, the effects in the information quality might be substantial. Another aspect, mentioned by Hanner, is that if the companies see the customer loyalty programs as unessential the post will be roughly calculated. This is something that will of course decrease the reliability.

### 6.2.3 Comparability

Comparability enables users to identify similarities and differences in the companies' accounting. It is affected by differences in inputs and the by reliability of the accounting. Comparability can be valued between companies' accounting or in a single company's accounting (Solomons 1986).

Solomons (1986) points out that to regulate the accounting is one of the best methods for reaching comparability between companies. The reason for implementing IFRIC 13 was to achieve a more comparable accounting between the companies since IAS 18 allows two ways of accounting customer loyalty programs and therefore practice is varies. With IFRIC 13 the companies only have one way to account for their customer loyalty programs. Consequently comparability will increase with IFRIC 13.

IFRIC 13, as discussed before, is a more rules-based accounting than IAS 18. According to Gibbins & Loewen (2005) IFRIC 13 will lead to a higher degree of comparability since the users will be able to compare the companies' accounting. Solomons (1986) claims that to reach comparability the data need to be based on consistent inputs but also on well chosen and complete inputs. The consistency factor will lead to a lower comparability with IFRIC 13, when looking at the fair value. Comparing one specific company's accounting over several years consistency is something that will result in a higher degree of comparability. But regarding comparability between companies the consistency will decrease this quality. This is so since the



fair value can be measured in different ways and is often based on subjective judgments. Our opinion is that estimations of the fair value will be difficult to compare. A factor that also will be difficult is the interpretation and implementation of IFRIC 13. Our experience is that IFRIC 13 is complicated and some issues are poorly defined. The accounting of customer loyalty programs will not be comparable if the implementation of IFRIC 13 will vary.



## 7. Conclusion

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*In this chapter we will state our conclusions based on the analysis. Finally we will give suggestions for further studies that have arisen during the writing of this thesis.*

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### **How do companies account for their customer loyalty programs?**

When answering the first question of this thesis we have not, as mentioned before, had the intention to generalize the companies' ways of accounting for customer loyalty programs. Out of the four companies that we have studied three of them follow the cost approach, paragraph 19 of IAS 18, and the fourth company, Lindex, follows the deferred revenue approach, paragraph 13 of IAS 18. The experiences of the companies and the accounting specialists are that the cost approach is the most common method. When looking at the comments received by IFRIC, on IFRIC 13 Customer Loyalty Programmes, most companies seem to use the cost approach method. This does not come as a surprise since most of the comments are unsupportive due to the fact that they use the cost approach and do not want to make the changes that will be necessary with an implementation.

### **How will IFRIC 13, Customer Loyalty Programmes, affect the information quality of the financial statements?**

When comparing the accounting information arising from the cost approach, paragraph 19, and IFRIC 13 our conclusion is that the accounting of IFRIC 13 more correctly depicts certain aspects of the economic events. The companies using the cost approach do not consider the fact that all of the revenues received have not yet been earned. IFRIC 13, on the other hand, defers revenues not yet earned and therefore more correctly depicts the economic events of the customer loyalty programs. From this point of view IFRIC 13 will render a higher validity on the accounting information. When using this perspective and comparing paragraph 13, not regarding the fair value, with IFRIC 13, we have come to the conclusion that the validity will not be affected since the accounting methods of the two regulations are prepared equally.

IFRIC 13 is a more rules-based accounting than IAS 18 since it is more detailed and offers fewer accounting solutions. The diversification of companies and the increased complexity of economic events make it difficult to use rules-based accounting. The customer loyalty programs are of a different nature. From this point of view IFRIC 13 renders financial statements with less validity than IAS 18. However, as mentioned before IFRIC 13 renders a higher validity compared to paragraph 19 when looking at the perspective of depicting the economic events of the customer loyalty programs. This makes it impossible to make a conclusion on the allover effects on the validity of the accounting information, when comparing paragraph 19 with IFRIC 13.



When accounting for the customer loyalty programs the companies have to make estimations as to how many of the award credits collected will be redeemed. The necessary judgements will make the accounting less reliable. However, the same estimations have to be made when following the requirements of IAS 18. Consequently, the reliability will from this point of view not be affected.

The major effects arising on the information quality of the companies' accounting when implementing IFRIC 13 regard the use of fair value. When using IAS 18 the cost allocated to the award credits will be reliable since it is the actual cost of fulfilling the award credits that will be used. The cost will be based on an invoice. When implementing IFRIC 13 the companies will have to consider that it is the fair value that has to be allocated to the award credits. This will not be a problem for ICA and Lindex, resulting in an unaffected reliability of their accounting. For goods and services sold by SJ and the airline industry there is no obvious fair value. Since judgements will have to be used in the preparation of their financial statements, reliability will decrease. We have come to the conclusion that IFRIC 13's effects on reliability will be different depending on the nature of the companies' customer loyalty programs. The differences depend on the reliability of the fair value allocated to the award credits.

The main reason for the development of IFRIC 13 is to obtain a more comparable accounting. One method of accounting for the customer loyalty programs would unquestionably lead to a better comparability between companies. This, of course, depends on the way that companies account for their customer loyalty programs today. If most of the companies nowadays follow paragraph 19, then comparability is already high. Since one of the companies studied follow paragraph 13 the comparability between the companies will be better when implementing IFRIC 13. However, IFRIC 13 will for some companies be complicated to implement regarding the fair value. When this is the case, IFRIC 13 might not lead to a better comparability. If the companies do interpret and implement IFRIC 13 equally, then there will be a better comparability. During this study we have gained the experience that this might not be the case. It is questionable if the validity arising with the use of fair value increases more than the reliability decreases, if looking at the companies that have difficulties when deciding the fair value of the award credits. If the implementation of IFRIC 13 leads to a larger increase in validity than the decrease in reliability, then comparability will increase.

Beginning this study we assumed that IFRIC 13 would have effects on the information quality of the companies' accounting. Our conclusion is that it indeed has, but the effects do not seem to be as essential as we expected. The companies interviewed all agree that the effects on the balance sheet arising from IFRIC 13 will not be essential. The main reason for this is that the revenue amount belonging to the award credits is unessential, as it is a very small part of the companies' revenues. There will be some effects but they will probably not be noticeable in the financial statements. Still, the effects might be greater on the first year of implementation. If the revenues belonging to the award credits would be of a valuable amount, then the consequences of the effects on the information quality would be more substantial. This could be the case for the airline industry, since they claim that IFRIC 13 leads to major effects on their balance sheet.



## **Suggestions for further studies**

Since IFRIC 13 is not yet implemented it would be interesting to perform a similar study once it has been implemented for a while. The companies might not see any effects arising from IFRIC 13 today, but once it has been implemented they might have another opinion. The results that we have come across might be different than what would be rendered after the implementation. It would also be interesting to perform a study on the airline industry alone since they claim to have major effects arising from IFRIC 13. Could their arguments be based on the fact that it will be quite costly for them to implement the new rules or will IFRIC 13 lead to major effects on their financial statements and thereby also on the information quality of those?



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Pettersson Emma, financial manager at Lindex in Göteborg, 27 November, 2007.

Tjärnström Helena, accounting manager at SJ in Stockholm, 30 November, 2007.



## Appendix 1 Interview questions for the respondents of the companies

1. What is your job title?
2. What is your background?
3. Which are your main work tasks?
4. How is the company's customer loyalty program constructed?
5. What is the reason for the company having a customer loyalty program and how important is it to the company?
6. How many members are included in your customer loyalty program?
7. Economically, how important is your customer loyalty program?
8. How does the company account for their customer loyalty program today?
9. What is the reason for the company to account for customer loyalty programs in this way?
10. Have there ever been any thoughts of accounting in a different way?
11. What variables are used when estimating the amount of award credits that will be redeemed?
12. Stated in percentage, how many of the award credits are not redeemed?
13. How will IFRIC 13 affect the information quality of the company's accounting?

Will further estimations and calculations be needed?

14. With IFRIC 13 it is the fair value that will be accounted for. How will this affect the information quality of the company's accounting?

How will you estimate the real value of the award credits when it is not obvious?

15. In the perspective of revenues, what changes will arise with IFRIC 13?
16. Which method is in your experience most adequate when accounting for customer loyalty programs?
17. Would you like to add anything?
18. Can we get back to you if any further questions should arise?



## Appendix 2 Interview questions for the accounting specialists

1. What is your job title?
2. What is your background?
3. Which are your main work tasks?
4. In your experience, how do companies account for their customer loyalty programs today?
5. What is the reason for companies to account for customer loyalty programs in this way?
6. What variables are used when companies estimate the amount of award credits that will be redeemed?

Will this change with IFRIC 13?

7. How will IFRIC 13 affect the information quality of the companies' accounting?

Will the same estimations and calculations be needed?

8. With IFRIC 13 it is the fair value that will be accounted for. How will this affect the information quality of the companies' accounting?

How will companies estimate the real value of the award credits when it is not obvious?

9. In the perspective of revenues, what changes will arise with IFRIC 13?
10. What will be the most difficult aspect of IFRIC 13 to implement?
11. Which industries will be most affected by IFRIC 13?
12. Which method is in your experience most adequate when accounting for customer loyalty programs?
13. Would you like to add anything?
14. Can we get back to you if any further questions should arise?