NANGIA & CO LLP
CHARTERED ACCOUNTANTS

Assurance Gazette

February 2024

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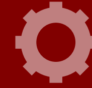
Foreword

The Assurance Gazette of February 2024 explores Ind AS 32, focusing on the accounting of convertible equity instruments. Companies must assess and classify these instruments accurately, reflecting their correct classification of debt and equity, ensuring transparency in financial reporting for stakeholders. The Gazette further provides a legitimate evaluation of the accounting aspects related to customer loyalty programmes, offering detailed insights into the deferred revenue and provision model. Customer loyalty programmes has been increasingly gaining popularity across e-commerce companies and other retail industries. Companies come up with innovative customer retention programmes in form of reward and loyalty points. Understanding accounting and valuation of such reward and loyalty points becomes crucial for companies, investors and the auditors considering its significant impact in the financial statements.

Accounting for Customer Loyalty Programmes



Introduction

Customer loyalty programs are marketing strategies designed to encourage customers and aims to foster a sense of loyalty among customers by providing them with rewards, incentives, and special offers. The goal is to retain existing customers, increase their lifetime value, and ultimately drive business growth.

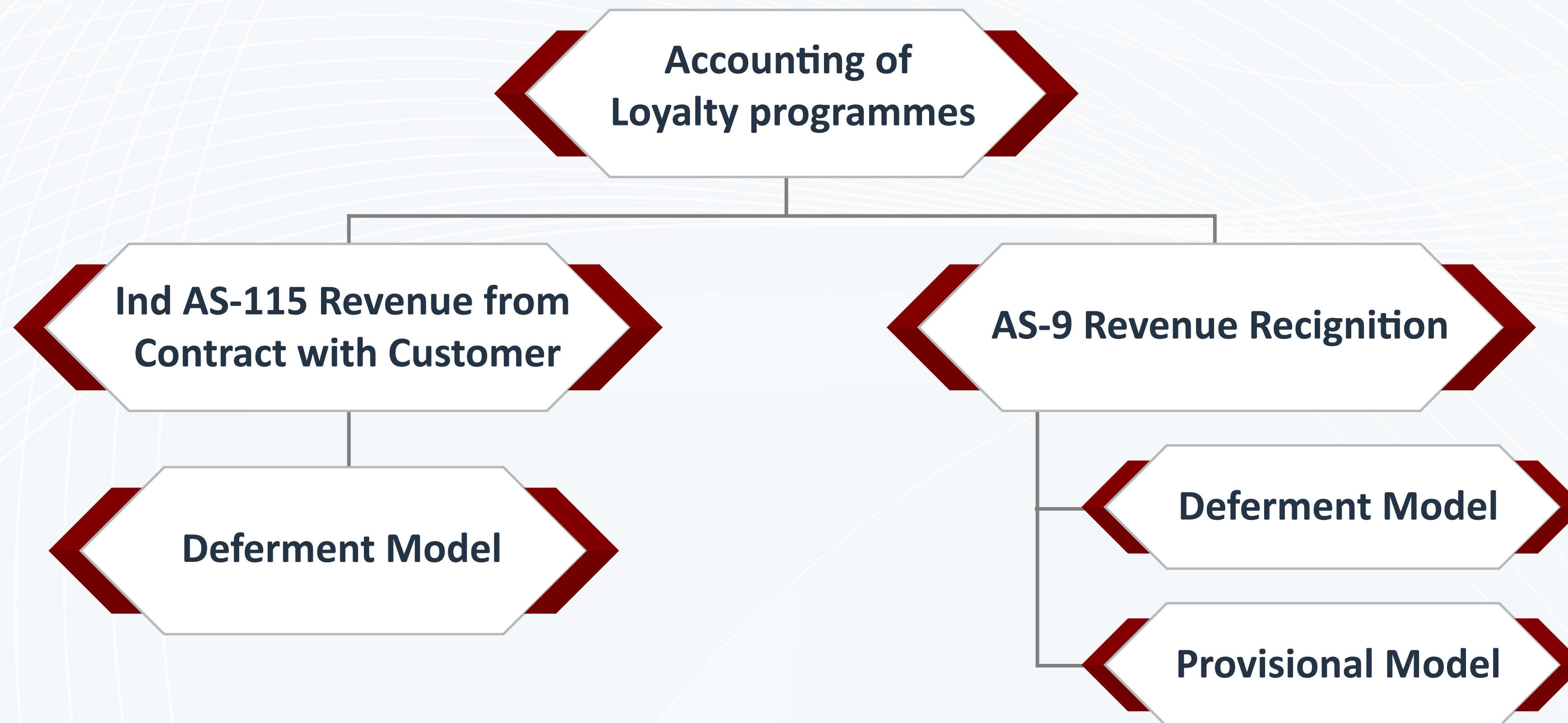
Customer loyalty points are a popular practice adopted by airlines, credit cards, telecom operators, retailers, hotels, fuel outlets, e-commerce companies.

There are various type of schemes or incentive programmes which are given below:

- Award that entitles the holder to discounted/free goods or services in the same website/mobile application. (Air miles issued by airlines/fuel stations).
- Award that the holder can use in stores within the same website/ mobile application or chain of website/ mobile application. (Ex Credit card points).
- Award of points in a programme administered by a third party.
- Entity transfers the obligation of redeeming awards to a third party in its entirely.

Under IGAAP framework, the accounting of such customer loyalty programmes of different complex arrangements has not directly been dealt with however the accounting of sale of goods and services under loyalty programmes is refined with issuance of INDAS. Accordingly, to bring parity, accounting of loyalty programmes is covered in "Guidance note on Accounting by E-commerce entities" for entities under I-GAAP framework.

Accounting of customer loyalty points



1. Award that entitles the holder to discounted/free goods or services in the same website/ mobile application

Deferment Model

1. Multiple element transaction
   - Provide initial goods or services.
   - Provide further good or services at discounting price/free against redemption of loyalty programme benefit.
2. Revenue recognises at time as follow.
   - **Initial sale.**

Cash/Bank.................................Dr.

Deferred revenue......................Cr.

Sale..Cr.

- **In subsequent financial year/period in which loyalty points redeem by customer.**

Deferred revenue.....................Dr.

Sale...Cr.

In this year entity will incur the cost towards redemption of points

COGS..................................... Dr.

Inventory.................................Cr.

Provisional Model

1. Single element transaction
2. Recognise entire revenue at time of initial sale and cost to be incurred in future with regards to the obligation to provide free/discounted goods or services, a provision required to be made.
3. Revenue recognises at time as follow.
   - **Initial sale.**

Cash/Bank.................Dr.

Sale............................Cr.

Marketing expenses................Dr

Prov. For marketing............................Cr.

- **In subsequent financial year/period in which loyalty points redeem by customer.**

Prov. For marketing.......................Dr.

Inventory.....................................Cr.

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2. Award that the holder can use in stores within the same website/ mobile application or chain of website/ mobile application

Customer can redeem awards issued by an entity either at its own website or third-party website and issuing entity retains the obligation for redemption till the points are redeemed by the customer. Similar accounting principles a stated above will apply with an additional consideration of determination of fair value of the credits vis-à-vis price at which goods are sold through different applications.

Where award credits are administered by third party, it may be difficult to predict whether customer shall redeem the point either at website of issuing entity or third-party website and accordingly, it may be presumed for accounting purpose that customer will redeem all award points within same website.

The accounting treatment remain the same as stated above in this case also except entity accounts for the payments to be made to the third party based on contractual arrangement with the third party.

If reliable estimates for redemption pattern can be made, then to the extent it is estimated that customer will redeem points at a third party application then provisions for amounts to third party should be made.

3. Award of points in a programme administered by a third party.

The issuer entity retains the obligation for redemption and third party merely acts as a service provider to facilitate the administration of the scheme.

The service fees of the third party for administering the scheme to be accounted based on contractual arrangement between the entity and the third party.

4. Entity transfers the obligation of redeeming awards to a third party in its entirely.

Such transfers can involve various agreements and arrangements between the original entity and the third party. The entity recognises the revenue in full on sale of goods/services and does not defer the any revenue as there are no further obligations to be fulfilled and also recognise income /expense on account of the transfer of obligations to the third party, as per the agreement.

Deferment model vis-à-vis provision model

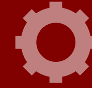
- Deferment and provision model both are in line with the matching concept, they only lead to a difference in the timing of recognition of revenue and cost.
- Deferment model is considered more appropriate and consistent with the accounting principles of revenue recognition however it involves complex working to arrive at the fair value of the award credit to be fulfilled in future. The model involves estimation of the expected redemptions basis established patterns and data in relation to this may not be readily available.
- As a practical expedient, provision model is considered as an acceptable alternate.

Nangia's Take

While both the provision and defement model align with the accounting principles and permissible, the choice of application of method would depend on factors such as nature of loyalty program, entity's financial goals, regulatory requirements, availability of financial information, ability to estimate and draw patterns basis past records and industry practice.

It therefore becoms necessary that the management evaluate impact and apply accounting after careful consideration as timing of recognition of revenue varies between the two. It is also recommended that such accounting is discussed and is acceptable by the investors and the auditors to avoid any ambiguities and appropriate reading of the financial statements specifically the top line.

Accounting of Convertible equity instruments



Background

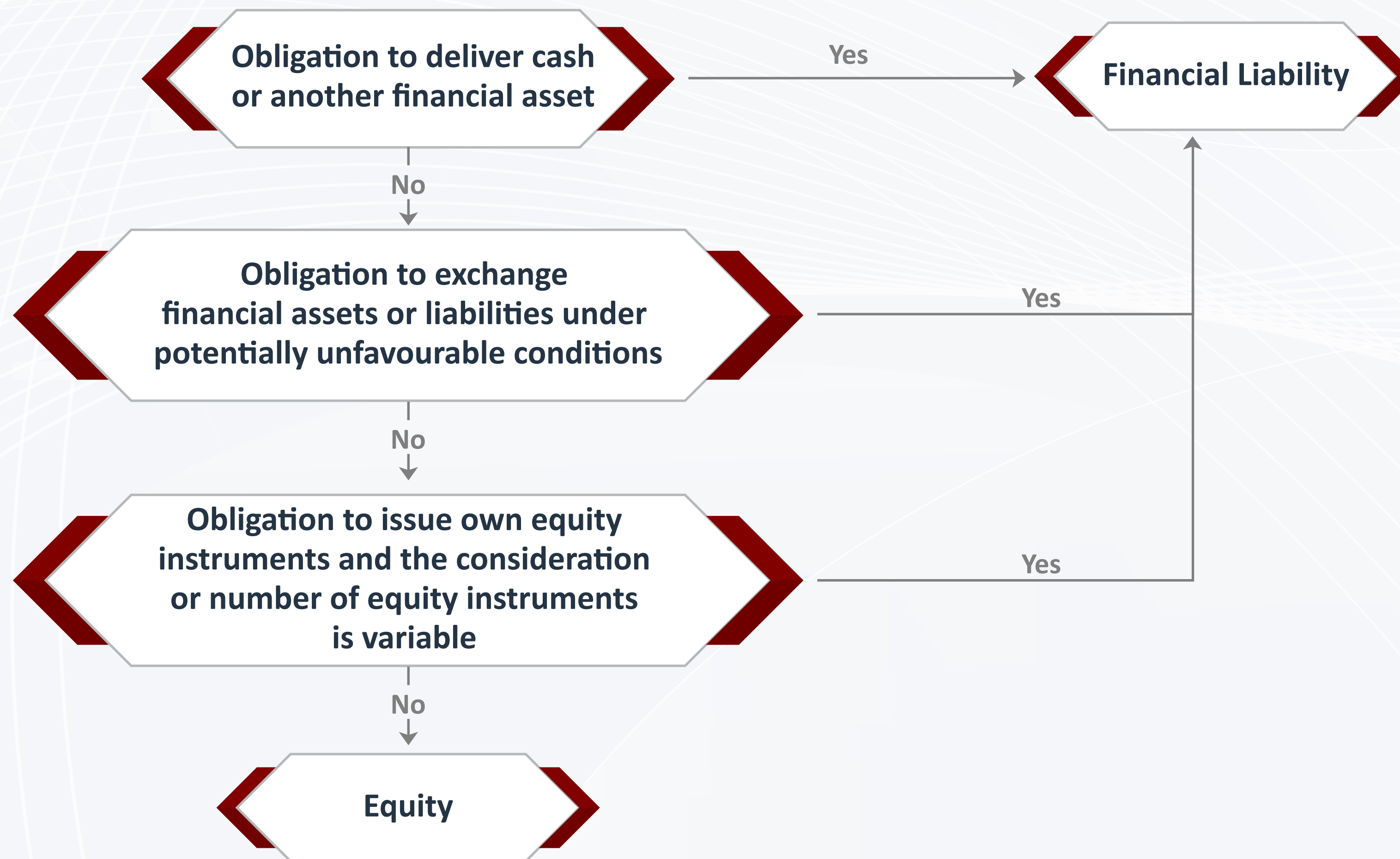
Under Ind AS 32, Companies are required to evaluate and classify convertible equity instruments based on their characteristics, determining the appropriate accounting treatment to accurately reflect the financial position and performance of the entity. Convertible equity instruments, as outlined in the Ind AS 32 (Financial Instruments: Presentation) and Ind AS 109 (Financial Instruments), represent a unique financial instrument that combines elements of both equity and debt. These instruments are issued as debt, such as bonds or loans, but have the option to convert into equity shares of the issuing company at a predetermined conversion ratio. From an accounting perspective, convertible equity instruments are initially recognized as debt, with the corresponding liability recorded on the balance sheet. Further since the conversion option provides the holder with the opportunity to acquire equity, it introduces an element of equity-like risk and potential dilution to existing shareholders. This classification ensures transparency and comparability in financial reporting, providing stakeholders with a clear understanding of the instrument's impact on the company's capital structure and overall financial health.

Analysis

A vital element which segregates a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party or to exchange financial asset or financial liabilities with holders under conditions that are potentially unfavourable to the issuer.

In accordance with Ind AS 32, an instrument is classified as equity if it adheres to the "fixed for fixed" requirement, meaning that the number of equity instruments issued and the corresponding consideration must be predetermined and fixed. Contracts that do not entail settlement by delivering a fixed number of shares against a fixed cash amount typically do not meet the criteria for classification as equity.

The following is the broad analysis of activities to be followed for this assessment:



Paragraph 11 of Ind AS 32 defines:

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

Further, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32.

Nangia's Take

In summary, the handling, categorization, and accounting demands associated with these instruments are intricate and necessitate the exercise of considerable discernment. These variations can substantially influence a company's balance sheet and income statement. The accounting implications, such as distinguishing between liabilities and equity, identifying embedded derivatives, and gauging liability, may fluctuate based on the specific provisions of the instrument and compliance requirements outlined in the Standard.

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