Accounting Treatment of Income from Credit Card Membership and Joining Fees and Credit Card Acquisition/Sourcing costs

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company is an unlisted, non-deposit accepting non-banking financial company registered with the Reserve Bank of India (RBI). The company is engaged in issuing credit cards to consumers in India.
2. As per the 'Notes to Accounts' in the financial statements for the financial year (F.Y.) 2013-14, following are the policies followed for the relevant income and expenditure:

    Notes to Accounts 1C (ii)- Income from membership fees and services:

    "Joining membership fee and first annual fee is recognised over a period of one year as this more closely reflects the period to which the fee relates to."

    The querist has stated that the joining fee is paid once in lifetime by some set of customers and the membership fee is paid annually. The company amortises only the joining fees and first annual membership fees over 12 months net of any credit/reversals/waivers given to customers. On payment of fees, the customers can use the credit card for managing their spends and all these customers are entitled to free credit period upto 50 days from the date of transactions.

    Notes to Accounts 1f (i)- Amortisation of card acquisition cost:

    "The productive sales force compensation, card acquisition cost (sales service provider expenses, incentives related to card acquisition, credit investigation cost and application printing cost), consumption of plastic cards and delivery charges are amortised over a period of one year. In the opinion of the management, the period of one year more closely reflects the period to which the costs relate to."

    The company incurs these costs for acquiring new customer who in turn pays the joining fees and membership fees. These costs are also amortised over next 12 months as the related income is also being deferred for next 12 months. According to the querist, as there are no specific provisions/guidelines for credit card industry on above components of income and costs, the company adopted above policies to disclose and present the financial statements in a more better way. The company has been following the above two policies consistently since F.Y. 2005-06. Before F.Y. 2005-06, the company used to recognise income and expenses on upfront basis without any amortisation.
3. The querist has stated that while adopting the above accounting policy, the management also referred the following pronouncements:

    Paragraphs 12 and 13 of the Accounting Standard (AS) 1, 'Disclosure of Accounting Policies' which allows management to choose more appropriate accounting principles and methods of applying those principles in differing circumstances:

    "12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

    13. The various standards of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view

of the differing circumstances faced by the enterprises."

For capitalisation/deferment of membership fees the following pronouncements have been referred by the querist:

Paragraph B(3c) of Illustrations to Accounting Standard (AS) 9, 'Revenue Recognition', inter alia, states as follows:

"Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto."

Paragraph B(6) of Illustrations to AS 9, inter alia, states as follows:

"If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided."

4. *Current method of income recognition from joining fees and membership fees:*

Fees/Income components	Remark
First year annual membership fees	Recognised over a period of one year net of all the credits/ waivers/reversals
Joining fees (once in life time)	Recognised over a period of one year net of all the credits/ waivers/reversals
Renewal membership fees (second year onwards)	Recognised as an when levied to the customer net of all the credits/waivers/reversals

Current process for amortisation of card acquisition costs:

Amortisation of cost elements	Remark
Directly identifiable costs : These costs are amortised in full without any adjustments over a period of one year	
Pay out to co-brand partner/ bank branches on the basis of per new card boarded/ membership fees received.	
Joining gifts, e.g., air tickets, movie tickets etc. to customers	
Purchase cost of plastic for the cards	
Card delivery/ pin mailer costs e.g. courier expenses, welcome pack stationary	Costs pertaining to new card/ accounts only in the new card ratio to total cards
Other costs which are deferred after some adjustments	
Third party costs for card sourcing (actual salary, rent, electricity, tele-calling, other office expenses incurred to solicit the card and to identify the prospective customer)	These costs (vendor infrastructure and staffing) are directly paid to the vendors for card sourcing activities, i.e., going in the market and acquiring a new customer. Further, the deferment is done only to the extent of success rate for the month, **For Example:** Total third party cost Rs. 100 Card success ratio (successful application as a % to total application received)–50% Cost deferred for 12 months - ₹100*50%=₹50 Cost expensed off immediately- ₹50
Credit bureau cost (CIBIL) paid to bureau per case	Deferred only to the extent of success rate for the month, Example same as above for third party costs
Credit investigation for applicant, paid to outside agency per case	Deferred only to the extent of success rate for the month, Example same as above for third party costs
Sales employee (FTE) payroll costs	First adjusted to arrive at the costs for origination activity (basis: yearly survey results, survey coverage > 50% employees across) and further deferred only to the extent of success rate for the month,

Amortisation of cost elements	Remark
	For Example: Total sales employee cost-₹100 % of time spent on card sourcing related activities (basis: annual survey of employees)-30% Total cost of sales employees for card sourcing–₹100*30%=₹30 Card success ratio (successful application as a % to total application received)–50% Cost deferred-₹30*50%=₹15 Cost expensed off immediately-₹85 (₹100 -15)

5. The statutory auditors for F.Y. 2013-14 have advised that the accounting policy adopted by the company needs to be reconsidered. In their opinion, all the income and expenditure should be booked as and when incurred rather than the practice being followed by the company. However, the management has adopted this policy in F.Y. 2005-06 considering the information provided in above paragraphs. Further, this policy has been consistently followed and disclosed in the notes to accounts of the company.

B. Query

6. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the current accounting policy followed by the company is appropriate or the company should make any changes in thi policy.

C. Points Considered by the Committee

7. The Committee notes that the issue raised by the querist relates to appropriateness of the current accounting policy followed by the company for recognition of joining fees and membership fees on credit cards and credit card acquisition costs (as detailed in paragraphs 2 and 4 above). Therefore, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, allocation of various elements of costs to determine card acquisition costs, accounting for waivers/reversals/credits allowed on the joining and membership fees, etc. Further, the Committee wishes to point out that the Committee has expressed its opinion purely from accounting perspective and not from legal perspective, such as, RBI Guidelines, if any, etc.

8. With regard to recognition of joining fees and membership fees on credit cards, the Committee notes the following paragraphs from Part 'B. Rendering of Services' of Illustrations to Accounting Standard (AS) 9, 'Revenue Recognition', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

> *"3. Financial service commissions*
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> A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:
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> (a) whether the service has been provided "once and for all" or is on a "continuing" basis;
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> (b) the incidence of the costs relating to the service;
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> (c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto."
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> *"6. Entrance and membership fees*
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> Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided

during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided."

The Committee notes from the Facts of the Case that joining fee is paid once in a life time and it entitles the customers to use the credit cards to manage their credit card spends. The Committee also notes that apart from such joining fee, the company also charges annual membership fee from the customers. Accordingly, the Committee is of the view that joining fee in the extant case confers only joining rights and not any other right/privilege and therefore, is similar to the membership fee in a case where other services are to be paid for separately. It gives rise to merely an entitlement for a customer to receive certain services against payment of the price. Accordingly, as stated in AS 9, such lumpsum amount should be treated as an income in the statement of profit and loss at the time of receipt. In respect of annual membership fee, the Committee notes that irrespective of whether it is first year annual membership fee or renewal membership fee (which is payable second year onwards), it is akin to annual charges for use of credit cards and the customers have to pay the annual membership fee annually every year for them to be entitled to receive the services of credit card during the year. Accordingly, considering the requirements of AS 9, the annual membership fees should be recognised on a systematic and rational basis over a period of one year to which such fees relate.

9. With regard to the accounting policy for recognition and amortisation of credit card acquisition costs as stated in the Facts of the Case, the Committee notes that the term 'amortisation' as per Accounting Standard (AS) 26, 'Intangible Assets' is "the systematic allocation of the depreciable amount of an intangible asset over its useful life". Thus, for amortisation of an item of cost, it is necessary that it should result in an 'asset'. In this regard, the Committee notes the definition of 'asset', paragraphs 95 and 96 of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, and paragraph 56 of AS 26, notified under the 'Rules' which provide as below:

Framework for the Preparation and Presentation of Financial Statements

"An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

"95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

AS 26

"56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. ..."

From the above, the Committee notes that the card acquisition costs in the extant case, although result into creation of credit card customers for the company from which future economic benefits are expected to arise, no tangible or intangible resource controlled by the company comes into existence. Accordingly, considering the above-reproduced requirements of the Framework and AS 26, no asset can be recognised and consequently, no such costs can be amortised over a period as an asset in the financial statements. Therefore, such costs should be recognised in the statement of profit and loss. With regard to the querist's argument regarding association of such costs with joining and membership fees, the Committee wishes to mention that even if an association of such costs with an item of income is to be established as per paragraph 95 of the Framework, the same can be more associated with the joining fee, which is received from the new customers and which, as discussed in paragraph 8 above, should be recognised as an income in the statement of profit and loss at the time of receipt of such income. Accordingly, the Committee is of the view that the card acquisition costs should be expensed and charged to the statement of profit and loss as and when these are incurred.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that the accounting policy of the company of recognising joining fees over a period of one year, recognising renewal membership fees immediately and amortisation of card acquisition cost is not appropriate, as discussed in paragraphs 8 and 9 above. The accounting policy should be modified accordingly.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on January 16, 2015. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty three volumes. A CD of Compendium of Opinions containing thirty three volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.