pwc

The Impact of "Deal of the day" Offers on Retail & Consumer Products Companies

Deal-of-the-day companies ("Deal Companies") offer daily deals to the general public. The "deals" offered by these companies are generally in the form of on-line coupons ("Deal Coupons"), providing discounts at local and nationwide businesses. The Deal Coupon industry has grown significantly in recent years. U.S. consumer spending on Deal Coupons is forecasted to increase from $873 Million in 2010 to $3.9 billion by 2015[1].

In 2010, there were approximately 63,000 separate deal-of-the-day offers in the U.S., with estimated consumer savings of approximately $1.26 billion. For 2011, projections show that savings traceable to deal-of-the-day offers may reach $3.0 billion[5].

There are currently approximately 350 Deal Companies in the U.S.[2] and this number is expected to grow. The larger players in the U.S. are facing competition from large internet and technology-based businesses. Further accelerating the popularity of deal companies and their websites is the astonishing increase in adoption of mobile devices by consumers. Nearly 110 million Americans are expected to have smart phones by the end of 2015 and time spent on mobile devices is rising faster than any other medium[3]. With worldwide smart phone and tablet usage increasing at a rapid pace, retail and consumer products ("R&C") companies are adapting their marketing and advertising strategies.

Given the increased popularity of on-line deal offers and use of mobile devices, for many R&C companies, on-line Deal Coupons have become a popular marketing tool to attract consumers and sell goods and services. This article highlights some of the related potential accounting, tax and business considerations for R&C companies that transact business via Deal Companies.

How it works

A typical deal-of-the-day offer is an offer to a consumer to purchase a Deal Coupon directly from the Deal Company's website. The consumer pays the Deal Company for the Deal Coupon, which provides a discount on merchandise or services at a particular vendor. These discounts are often more than 50%. Deal Companies generally structure the deals such that they retain a percentage of the consideration paid by the consumer.

For most deals, this percentage is outlined in a contractual arrangement between an R&C company and a Deal Company. The consumer can then redeem the Deal Coupon on-line or at the respective store or business. In the first quarter of 2011, the most popular Deal Coupons were related to food and drink offers (restaurant and products), which accounted for 27% of the total deals offered, followed next by beauty, spa and massage offers (19%), and sports and recreation offers (14%)[4].

[1] Source: BIA/Kelsey 2011..

[2] Source: Business Wire, July 14, 2011.

[3] Source: PwC 2011 GMA Financial Performance Report.

[4] Source: "The Daily Deal Phenomenon: A Year in Review, March 2011" - Local Offer Network.

[5] Ibid.

The accounting implications

Accounting considerations for R&C companies related to Deal Coupons will be dependent on the specific terms of the agreement with the Deal Company and the obligation to the consumer. Some of the key factors that should be considered are:

- *Revenue recognition*: Who is the customer of the R&C company - the Deal Company or the end consumer — and similarly, who is the principal/agent in the transaction with the consumer and what is the nature of the offer?
- *Inventory valuation*: Are there any net realizable value ("NRV") issues related to inventory that will be used to fulfill the offer?
- *Income Tax*es: What are the state and local tax considerations? Are there any federal income tax implications?
- *Escheatment*: What are the abandoned and unclaimed property considerations, if any, for unredeemed coupons?

It is important to note that each deal-of-the-day offer may be different and the terms of each contractual arrangement between the R&C company and the Deal Company should be understood and evaluated to determine the appropriate accounting and tax considerations.

An example

Consider the following example:

On September 1, 2011, Deal Company A's website showcases Retailer B in its deal-of-the-day offer. Deal Company A sends an email to all of its subscribers notifying them of the opportunity to purchase a $100 Retailer B Deal Coupon for a payment of only $50. Deal Company A will retain $10 of the $50 paid as a marketing fee and remit the remaining $40 to Retailer B. The Deal Coupon will expire if not used within a year from September 1, 2011. At the time the Deal Coupon is redeemed by the consumer, the cost of the product sold by Retailer B is $25.

Some of the key accounting implications for the deal are as follows:

- <u>Revenue recognition</u>

It is important to assess the principal/agent structure in the transaction. ASC 605-45, *Principal Agent Considerations,* includes examples of indicators to be analyzed and weighted in this assessment. Relevant indicators include, but are not limited to, the following:

- *Who is responsible for providing the product or service?*
- *Who has the general inventory risk?*
- *Who establishes the price?*
- *Who bears the credit risk?*
- *Who bears the risk of physical inventory loss?*

Let's assume that in this example that Retailer B concluded it is the principal in the transaction and should report revenue based on the "gross" amount billed to the consumer. The amount of revenue ultimately recorded by Retailer B is limited to the consideration paid by the consumer for the Deal Coupon. In this example, Retailer B would record $50 of deferred revenue at the time the Deal Coupon is purchased by the consumer and recognize the revenue when the consumer buys the merchandise or service from Retailer B with the Deal Coupon.

The difference between the $50 of revenue to be recorded and the cash receipt of $40 by Retailer B represents the marketing fee charged by Deal Company A. The accounting for this marketing fee by Retailer B depends on the elected accounting policy for deferring cost of services. Companies may make a policy election to either defer the marketing fee (and recognize the expense in proportion to the revenue recognized), or expense the marketing fee as incurred[5].

It is important to note that a company's accounting policy/method for deferring costs should be applied consistently to all arrangements. When the effect of the deferral could be material, companies should disclose its deferral policy and nature of the costs that are deferred.

For example, Retailer B can elect a cost deferral policy based on the guidance in ASC 605-20-25, *Separately Priced Extended Warranty and Product Maintenance Contracts*[7]. In this scenario the marketing fee is deferred until the redemption of the Deal Coupon by the consumer. The following journal entries would be recorded by Retailer B:

At the time of purchase of the Deal Coupon by the consumer

Dr.	Account Receivable	$40	
Dr.	Deferred Marketing Fee	$10	
Cr.	Deferred Revenue		$50

Cash receipt from the Deal Company

Dr.	Cash	$40	
Cr.	Account Receivable		$40

Redemption of the Deal Coupon by the consumer

Dr.	Deferred Revenue	$50	
Cr.	Revenue		$50
Dr.	Marketing Expense	$10	
Cr.	Deferred Marketing Fee		$10
Dr.	Cost of Goods Sold	$25	
Cr.	Inventories		$25

Please note that if Retailer B had a previously elected cost deferral policy for other arrangements, this policy would also apply to the marketing fee in this example and the existing policy would generally not be modified.

- Inventory valuation

Given the significant discounts offered, R&C companies should carefully assess the recoverability of inventory to fulfil deal-of-the-day offers.

Deal-of-the-day products and services are generally offered at significant discounts from regular prices. The average price per Deal Coupon in 2010 was $42.45, representing a 53% discount from regular prices[6].

Inventories generally need to be stated at the lower cost or market[7]. The use of the net realizable value concept as the appropriate measure of market depends on the facts and circumstances. Certain non-recurring discounts on regular prices may not be indicative of the underlying market prices of a product and therefore excluded from the NRV calculation. However, significant discounts could result in a recoverability issue for the inventory that will be used to fulfill the offers. In situations where R&C companies plan to frequently use deal-of-the-day offers to liquidate inventory, and the estimated net selling price is below the cost of the product sold, R&C companies should assess the need for potential inventory provisions/write downs.

For R&C companies using the retail inventory method, the use of Deal Coupons should be closely monitored to ensure that the deal offers are appropriately considered in the markdown analysis.

[5] Refer also to SAB Topic 13.A.3f. The policy election to defer cost is based on the models under ASC 605-20-25-4 and ASC 310-20-25-2.

[6] Source: "The Daily Deal Phenomenon: A Year in Review, March 2011"- Local Offer Network.

[7] Please note that the tax basis may differ.

- Tax implications

There may be book and tax differences for accounting for deal-of-the-day offers. For example, for Federal income tax purposes, revenue generally can only be deferred for a limited period of time whereas for book purposes companies may be eligible to defer for a longer period. In addition, the book and tax treatment of the marketing fees payable by the R&C companies to the Deal Companies may differ.

The sales and use tax law around Deal Coupons and gift cards is developing. Given that combined state and local sales and use tax rates can exceed 10 percent, the indirect tax consequences, including the potential collection requirements related to deal-of-the-day offers could become significant.

There can also be various state tax issues related to deal-of-the-day offers. One of the key areas relates to sales and use tax matters. The sales and use tax law with respect to Deal Coupons is still being developed by state tax authorities. Therefore, depending on how states interpret the Deal Coupon transaction, the impact on R&C companies will vary.

Sales and use taxes are transaction-based taxes imposed on "sales" of specified products (goods and services). Key to understanding the sales and use tax treatment of a Deal Coupon is defining what represents the sale, followed by an analysis of what is included in the sales price.

States may treat Deal Coupons as regular retailer coupons, with the sale occurring at the register (or on-line check-out). Regular retailer coupons and discounts are generally not included in the sales price[8]. In the previous example, the consumer paid $50 for a $100 Deal Coupon, representing a discount of up to $50 and leaving $50 of sales price subject to sales tax (assuming no more than $100 of taxable goods and services are purchased). Note the $10 marketing fee paid by Retailer B is not a discount to the consumer, who actually paid $50, and will likely not further reduce the sales price.

This treatment would be different than the current sales tax treatment of gift cards by states. The purchase of a gift card is a nontaxable purchase of an intangible right, with the gift card becoming the consideration for the product ultimately purchased. While the Deal Coupon may only be used once, does not have a retained value and often has a limited expiration date, there may be characteristics that are similar to gift cards. For example, a Deal Company may advertise to consumers that they may purchase Deal Coupons as "gifts". If in our example the Deal Coupon is treated as a gift card for sales tax purposes, the taxable event will again take place at the register or on-line check-out, but the sales price subject to tax could be equal to the amount redeemed at the register or on-line check-out.

- Escheatment implications

Deal Coupons generally have a limited expiration date (one year or less). After the expiration date, some Deal Companies and/or the R&C companies participating in the offer may issue a credit for the amount paid towards future deals but the coupon may not be redeemed for the full coupon value.

States have varying rules on the escheatment of abandoned and unclaimed property. Many states are increasingly expanding their unclaimed property laws to gift cards and similar instruments, and are decreasing the holding periods after which such property must be remitted to the state. Further, states are seeking in some cases to subject the entire "face value" of these instruments to escheatment, rather than limiting escheatment to a percentage representing the cost to the R&C company[9].

In this environment, deal-of-the-day offers raise a number of questions. For example, who is the issuer of the Deal Coupon, and who is responsible for the escheatment liability? Who is the "purchaser", the consumer, or the Deal Company as a "reseller" of the Deal Coupon?

[8] Please note that rules may differ by state and the exclusion does generally not apply when the R&C company is reimbursed for the coupon or discount by a 3rd party.

[9] Refer to the Model Uniform Unclaimed Property Act for further details.

These abandoned and unclaimed property questions have yet to be decisively answered by the states. It is essential for R&C companies to understand the escheatment responsibilities based on the contractual terms with the Deal Company and the law of each state. R&C companies with breakage policies should carefully assess whether there is sufficient history of redemption experience in order to conclude that the likelihood of redemption of the Deal Coupon is remote.

The answer to these questions depends on the contractual provisions which could dictate who is responsible for remitting unclaimed property to the state. In addition, companies should also address these questions in the context of the principal/agent evaluation for revenue recognition purposes.

An R&C company may determine that there is no legal obligation to remit the value of unredeemed Deal Coupons to the relevant jurisdictions as abandoned property. As a result, once the likelihood of the Deal Coupon being redeemed by the consumer is remote, the company could elect a policy to record breakage income on the unredeemed Deal Coupons. In these circumstances, companies should carefully assess their breakage policy. For example, there may be insufficient history of redemption experience and therefore breakage income can only be recorded upon the ultimate expiration of the Deal Coupon. In addition, the deferred marketing fees associated with the Deal Coupon may have to be expensed once the breakage income is recorded.

Finally, if the R&C company concludes the Deal Coupon is subject to escheatment and that it is responsible for remitting the property to the state, it must determine the amount to be remitted. Is it the face value of the Deal Coupon, the amount the consumer paid for the coupon, the amount the R&C company is entitled to receive on the ultimate retail sale, or some other value? If the Company determined that the face value of the Deal Coupon is subject to escheatment, this could result in an additional reserve that needs to be recorded for property to be remitted to the state.

The business impact

R&C companies have traditionally tried to reach consumers and generate sales through a variety of methods such as the yellow pages, direct mail and catalogues, newspapers, various advertisements and promotions. The Deal Companies have created a new way to attract consumers and sell goods and services. Participating in a deal-of-the-day offer may require special business considerations. Examples of factors to consider include:

- The Deal Coupons allow R&C companies to offer distinctive prices to different consumers and can benefit R&C companies in terms of marketing and advertising, for example by generating additional traffic to the company's existing selling channels. However, in order for a deal offer to generate value for the R&C companies, they should consider the broader brand awareness and impact of using such offers. For example, does the pricing for the deal-of-the-day product or service set a new consumer expectation regarding pricing for similar products or services?
- Deal-of-the-day offers may involve high volumes of product and could create a significant burden on a company's supply chain and increase staffing needs for a relative short period of time.

There may also be internal controls, system and process implications, for example as it relates to sales tax and tracking used and unused coupons.

Conclusion

The continuing increase in digital marketing, combined with the increased use in smart phones and other devices will likely further increase the popularity of on-line Deal Coupons, which presents significant opportunities for R&C companies. As discussed in this article, deal-of-the-day offers raise a number of accounting, tax and business questions for R&C companies. A detailed understanding of the contractual arrangement with the Deal Company, as well as the various tax and escheatment considerations is critical when evaluating these arrangements.

For further questions on the content in this article, please contact any of the PwC professionals listed below.

Sue McPartlin
US R&C Industry Leader
513-361-8094
susan.m.mcpartlin@us.pwc.com

Steve Barr
US R&C Assurance Leader
415-498-5190
steven.j.barr@us.pwc.com

Barbra Bukovac
US R&C Tax Leader
312-298-2563
barbra.bukovac@us.pwc.com

Ryan Swincicki
US R&C Quality & Technical Leader
614-629-5321
ryan.n.swincicki@us.pwc.com

Janet Gagliano
US Abandoned and Unclaimed Property Leader
678-419-1068
janet.c.gagliano@us.pwc.com

Peter Schlicksup
National Professional Services Group R&C Partner
973-236-5259
peter.j.schlicksup@us.pwc.com

Significant contributor to this article:
Willem Voorthuijsen
R&C Assurance Senior Manager
973-236-5049
willem.voorthuijsen@us.pwc.com