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Issues and solutions for the retail and consumer goods industries

*A Comparison of
International
Financial Reporting
Standards and
US GAAP*

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Foreword

We first published 'Issues and Solutions for the Retail and Consumer Goods Industries' in 2008 to provide perspectives on a range of financial reporting issues specific to the retail and consumer goods (R&C) sector.

Recent economic conditions have been challenging to many R&C companies around the globe and have shown the interconnected nature of the world's capital markets. Conditions have also demonstrated the importance of achieving greater transparency and a common accounting language that will enable investors to make more informed capital allocation decisions.

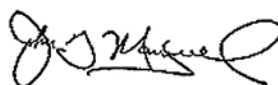
Global transition to International Financial Reporting Standards (IFRS) has continued to gather pace as countries around the world start to allow or incorporate IFRS into their local standards for both public and private companies, and ongoing convergence efforts between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) will bring further change in the coming years.

We have taken the opportunity to update this publication taking specific accounting challenges that PwC's global network of R&C engagement partners and their clients have been dealing with in responding to these challenges.

We have combined this knowledge with that of our accounting consulting services network to prepare an extensive set of accounting solutions to help you understand and debate the issues and explain some of the approaches often seen in practice. We hope this will encourage consistent treatment of similar issues across the sector.

Our framework focuses on generic issues rather than specific facts and circumstances, and it does not necessarily address the exact situations that might arise in practice. Each situation should be considered on the basis of the specific facts and in most cases the accounting treatment adopted should reflect the commercial substance of the arrangements. We encourage you to discuss the facts and circumstances of your specific situations with your local PwC R&C contact.

We hope that you find the publication useful in addressing your own reporting challenges.



John Maxwell

Global Retail & Consumer Leader



David Mason

Chairman, Retail & Consumer
Industry Accounting Group

Introduction

This publication summarises some of the complex accounting areas that are specific to the R&C sector based upon applicable standards as of December 31, 2011. This publication does not address the impact of the ongoing standard-setting activities of either the IASB or the FASB.

Some aspects of technical accounting under both IFRS and US GAAP are complex but common to all sectors—such as financial instruments, share-based compensation, business combinations and pensions. These are not addressed in this publication. For discussions regarding the impact of exposure drafts, such as ‘Revenue from Contracts with Customers’ and ‘Leases’, please refer to www.pwc.com/r&c.

The R&C sector

The R&C sector comprises three main participants: the supplier (referred to as ‘CPG company’), the retailer and the final customer.

The CPG company is usually a producer of mass products. It earns its revenue from the retailer but must also convince the customer to buy its products.

The retailer is the link between the CPG company and the consumer. The retailer’s activity typically comprises the purchase of products from the CPG companies for resale to customers.

The customer is the consumer who purchases products from the retailer.

This publication explains the accounting issues that arise throughout the R&C value chain, from the innovation function of the CPG companies to the sales and marketing function of the retailers. The issues we have addressed are summarised by reference to their point in the value chain and the aspects of the business model affected.

US GAAP considerations

Where the possible treatment for a particular accounting issue might differ between US GAAP and IFRS, we have highlighted areas for further consideration.

Key




	US GAAP and IFRS are similar
	The overall approach to US GAAP is similar to IFRS, but detailed application needs to be carefully assessed as significant differences may arise from specific issues
	Specific differences between US GAAP and IFRS may exist

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A man in profile, wearing a light-colored jacket, is looking towards a display of denim clothing in a store. The display consists of several racks of jeans and jackets, with some items hanging and others folded on shelves. The lighting is warm and focused on the clothing.

***Innovation, brand,
R&D and licensing***

1. Development costs



Background

A detergent manufacturer incurs significant costs developing a new technology that allows consumers to wash clothes significantly quicker.

Issue

Are the development costs incurred by the CPG company capitalised as an intangible asset?

Relevant guidance

Development activities are defined in IAS 38 as *‘the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.’*

IAS 38.57 states that *‘An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:*

- (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.*
- (b) Its intention to complete the intangible asset and use or sell it.*
- (c) Its ability to use or sell the intangible asset.*

(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.’

Solution

Development costs should be capitalised if all the criteria in IAS 38.57 are fulfilled. It is sometimes difficult to determine the point at which the criteria are met. The Company would need to map its development ‘stage-gate’ process to the above criteria to determine if and when the criteria to capitalise costs are met.

US GAAP comment

Development costs are expensed as incurred in accordance with ASC 730, ‘Research and Development.’

2. Brands and CGUs



Background

Company A acquires Company B. Both operate in the same consumer goods sector.

After acquisition, Company A intends to integrate the manufacturing of Company B's products into its own facilities and close Company B's manufacturing facilities.

Brand recognition is important in this sector. Company A will continue to sell products under Company B's brand after integration of the manufacturing facilities. The brand will not be licensed out and has an indefinite life.

Issue

Management believes that most of the value of the acquired business is derived from the brand. As the acquired manufacturing facilities are not required to support the brand, management considers the brand to be a separate cash generating unit (CGU). Is this supportable?

Relevant guidance

A CGU is defined as the 'smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or other groups of assets' [IAS 36.6].

Solution

A brand usually increases the revenue from sales of a product. The revenues from sales of a branded product cannot be split between that generated by the brand and that generated by the production facilities. Brands are typically not a separate CGU under IFRS and are not tested for impairment individually. The brand is tested for impairment together with the associated manufacturing facilities.

US GAAP comment

In accordance with ASC 350, 'Intangibles—Goodwill and Other', as the brand has an indefinite life, the intangible asset is not grouped with other assets when testing for impairment. Rather the indefinite-lived intangible asset is tested on a stand-alone basis.

3. Useful life of brands



Background

A luxury goods company has acquired two fragrances for its product range:

- A perfume that is a timeless classic and has been a flagship product for many decades; and
- A new perfume named after a newly-famous pop star who has been actively involved in promoting and marketing the fragrance.

Issue

Management is unable to estimate the useful life of either fragrance and therefore proposes to treat both brands as having an indefinite life. Is this appropriate?

Relevant guidance

Intangible assets have an indefinite useful life when there is no foreseeable limit to the period over which, based on an analysis of all relevant factors, the asset is expected to generate net cash inflows for the entity [IAS 38.88].

In this situation, factors that might be considered include:

- The entity's commitment to support the brand;
- The extent to which the brand has long-term potential that is not underpinned by short-term fashion or market trends but has been proven by its success over an extended period; and
- The extent to which the products carrying the brand are resistant to changes in operating environments. The products should, for example, be resistant to changes in the legal, technological and competitive environment.

Solution

The timeless classic brand is likely to have an indefinite life. The brand has already proven its longevity by having been successful in the market for many decades.

The perfume named after the newly-famous pop star is most likely linked to the popularity of the star; therefore it is difficult to assess whether the brand would survive beyond the life or even the media life of the star. It is also a new product, and its longevity has not been proven. It is unlikely that this brand has an indefinite life.

US GAAP comment

There is specific guidance in ASC 350, 'Intangibles—Goodwill and Other' that should be considered when estimating the useful life of an intangible asset. This is similar to the IFRS guidance, although in specific circumstances may be more stringent/lenient.

The useful life of an intangible asset is considered indefinite if no legal, regulatory, contractual, competitive, economic or other factors limit its useful life to the entity.

However, based on the above considerations, the perfume named after the famous star would likely have a finite life.

4. Up-front fees



Background

Luxury brand C grants Manufacturer B the exclusive rights to produce and sell glasses under brand C. Design of the products are to be agreed by C.

Under the 10-year license agreement, Manufacturer B pays Luxury brand C a CU 100 non-refundable up-front fee and an annual royalty calculated as a percentage of net sales, with a minimum of CU 10 a year.

The agreement is cancellable after five years should Manufacturer B not meet minimum revenue levels.

Issue

How should this up-front fee be accounted for?

Relevant guidance

Royalties paid for the use of the licensor's asset (the consumer brand) are normally recognised on an accrual basis in accordance with the substance of the agreement [IAS 18.30].

Example 20 of IAS 18 states: *'Fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognised in accordance with the substance of the agreement. As a practical matter, this may be on a straight-line basis over the life of the agreement; for example, when a licensee has the right to use certain technology for a specified period of time.'*

Solution

The up-front fee should be spread over the expected sales volume to be made in the future or over the duration of the license agreement.

Note: The timing of the recognition of up-front fees that involve licensing arrangements could be impacted by the new converged standard on revenue when issued.

5. Sales to a franchisee



Background

In exchange for an up-front payment of CU 100,000 a franchisor grants a five-year franchise to an overseas company to accelerate its global expansion. No other services will be provided by the franchisor.

The franchisor specialises in Product A, which has a usual selling price of CU 100, and agrees to sell this product to the franchisee for CU 70 throughout the franchise period.

Issue

- (a) How does the franchisor account for the up-front payment?
- (b) How is the sale of Product A accounted for by the franchisor?
- (c) How is the up-front payment accounted for by the franchisee?

Relevant guidance

Fees charged for the use of continuing rights granted by a franchise agreement or for other continuing services provided during the agreement's term are recognised as revenue as the services are provided or the rights are used [IAS 18 App 18].

When the relevant criteria are met, service revenue is recognised by reference to the stage of completion of the transaction [IAS 18.20].

An asset meets the identification requirement in the definition of an intangible asset when it:

- a) is separable—i.e., is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

- b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations [IAS 38.12].

Solution

- (a) The franchisor recognises as revenue the up-front fee as units of Product A are delivered to the franchisee over the five-year period of the contract, or pro rata over the duration of the franchise arrangement.
- (b) Sales to the franchisee are treated in the same way as the sale of goods to other customers.
- (c) The franchisee should recognise an intangible asset (distribution rights) and amortise it over the five-year period.

US GAAP comment

In accordance with ASC 952, 'Franchisors', the up-front revenue received should be allocated to the units sold to provide a reasonable profit when the price of goods does not provide the franchisor with a reasonable profit. In practice it is not uncommon for the franchisor to recognise the fee relating to the access to the franchise on a straight line basis when the franchisor is unable to estimate the amount of units expected to be sold over the term of the franchise arrangement.

Note: The accounting for franchise arrangements could be impacted by the new converged standard on revenue when issued.

6. Franchise arrangements



Background

A retailer grants a five-year franchise to an overseas company to accelerate its global expansion. The franchisee makes an up-front payment of CU 100,000 for access to the franchise.

The retailer specialises in Product A, which it purchases for an average cost of CU 60. The retailer agrees to arrange for the ordering and delivery of this product to the franchisee for a charge of CU 60, resulting in nil profit. The contract allows the franchisee to set the local sales price, but it has no right to return any inventory to the retailer.

Issue

How does the retailer account for the arrangement with the franchisee and, in particular, the sale of Product A to the franchisee?

Relevant guidance

'Revenue shall be measured at the fair value of the consideration received or receivable' [IAS 18.9].

'...in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity

for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission' [IAS 18.8].

'Transactions may take place between the franchisor and the franchisee which, in substance, involve the franchisor acting as agent for the franchisee. For example, the franchisor may order supplies and arrange for their delivery to the franchisee at no profit. Such transactions do not give rise to revenue' [IAS 18 App 18d].

Solution

The retailer/franchisor is acting as the purchasing agent on behalf of the franchisee. It does not bear the inventory risk and is not setting the final customer sales price. The retailer/franchisor recognises its margin as revenue, which in this case is nil. This is compensated for by the up-front fee, which should be recognised as revenue by the retailer/franchisor, spread in an appropriate manner over the life of the franchise agreement.

Note: The accounting for franchise arrangements could be impacted by the new converged standard on revenue when issued.



Marketing and advertising

7. Advertising costs



Background

A company arranges for an external advertising agency to develop and design a new advertising campaign. The campaign will cover television and press advertising and is split into three phases: design, production and placement. An initial contractual payment of CU 3 million is made three months prior to the year end.

The design and production phases are complete at the year end. The estimated cost of the placement phase is CU 1 million.

Issue

How is the payment to the advertising agency treated at the year end?

Relevant guidance

Under the guidance in IAS 38.68-70 advertising and promotional expenditure is recognised as an expense when incurred. IFRS does not preclude recognising a prepayment when payment for the goods or services has been made in advance of the delivery of goods or rendering of services.

IAS 38, 'Intangible Assets' states that an expense is recognised when an entity has the right to access the goods or the services are received.

Solution

The CU 2 million paid for the design and production of the campaign does not qualify as an asset because the entity has access to the output from those services. These costs are expensed as incurred before the year end. The CU 1 million placement costs are treated as a prepayment at year end and expensed in the following period when those services are delivered.

US GAAP comment

In most instances, the CU 2 million related to the development and conception of a new advertising campaign is usually considered as 'Other than direct-response advertising' under ASC 720-35, 'Advertising Costs.' It can therefore be either (1) expensed as incurred or (2) deferred and then expensed the first time the advertising takes place. The method selected is an accounting policy choice for the company and must be applied consistently to similar transactions.

Consistent with IFRS, the remaining CU 1 million related to placement is recognised as a prepayment at year end.

8. Point-of-sale advertising



Background

Advertising and promotional activities include point-of-sale advertising through catalogues, free products and samples distributed to consumers.

A cosmetics company purchases samples and catalogues to promote its brands and products.

At year end, the cost of samples and catalogues held is CU 50. These items are stored and will be distributed in the following quarter, when a new product is launched.

Issue

When are the costs expensed?

Relevant guidance

Under the guidance in IAS 38.68-70 advertising and promotional expenditure is recognised as an expense when incurred, but IFRS does not preclude recognising a prepayment when payment for the goods or services has been made in advance of the delivery of goods or rendering of services.

IAS 38.69 states that an expense is recognised when an entity has the right to access the goods or the services are received.

Solution

The cost of the samples and catalogues is expensed when the entity takes title to these goods. It is not carried forward as an asset.

US GAAP comment

Sales materials, such as brochures and catalogues, may be accounted for as prepaid supplies until they are no longer owned, transferred to a third party, consumed or no longer expected to be used—in which case their cost is a cost of advertising [ASC 720-35, 'Advertising Costs'].

9. Coupons



Background

A soap manufacturer sells a product for CU 20. The packaging includes a price reduction coupon of CU 2, redeemable on a subsequent purchase of the same product.

The manufacturer has historical experience that one coupon is redeemed for every two issued.

One thousand packs of the soap, which include a price reduction coupon, have been sold.

Issue

How does the manufacturer account for the coupons?

Relevant guidance

Where coupons are issued as part of a sales transaction and are redeemable against future purchases from the seller, revenue is recognised at the amount of the consideration received less an amount deferred relating to the coupon [IFRIC 13.5/ASC 605-50].

Solution

The consideration allocated to the reduction coupon is presented as 'deferred revenue' in the balance sheet and is measured at the fair value of the coupon.

The face value of the coupon to the customer is CU 2. The face value is adjusted by the proportion of coupons expected to be redeemed (50%), so its fair value is CU 1 (CU 2 x 50%).

When the revenue is deferred using the fair value of the coupon, the cash received of CU 20,000 (CU 20 x 1,000) is allocated to revenue (CU 19,000) and deferred revenue (CU 1,000). Revenue of CU 2 is recognised when each coupon is redeemed.

Note: A relative fair value approach can also be taken.

10. Marketing expenses at interim periods



Background

An entity will spend CU 10m on a marketing campaign with the benefits of the campaign expected in the second half of the year. At the interim reporting date all the costs have been incurred.

Issue

Can management defer any of these costs at the interim reporting date to match the expected inflow of benefits from the campaign?

Relevant guidance

As noted in solutions 7 and 8, advertising and promotional expenditure is recognised as an expense when it is incurred [IAS 38.68-70], but IFRS does not preclude recognising a prepayment when payment for the goods or services has been made in advance of the delivery of goods or rendering of services [IAS 38.68-70].

In addition, IAS 34.39 states that *'costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.'*

Solution

The CU 10m spent on the campaign should be expensed as a first half-year item (i.e., when it was incurred) in the same way as it would be at the year end, unless the spend was on services not yet received (e.g., prepaid airtime) in which case a prepayment would be held on the balance sheet until those services are received.

US GAAP Comment

Under US GAAP (ASC 270, 'Interim Reporting') costs and expenses other than product costs shall be charged to income in interim periods as incurred, or be allocated among interim periods based on an estimate of time expired, benefit received or activity associated with the periods. This could lead to a situation where costs incurred in the first half of a fiscal year related to the annual period may be deferred into future interim periods. Advertising expenses should, however, only be deferred when the benefits of the expenditures clearly extend beyond the interim period.



Selling to retailers

11. Trade loading



Background

An electronics CPG company enters into the following arrangements before the year end to boost sales:

- (a) An arrangement with one of its major retailers, under which the retailer will buy an unusually high volume of television sets in December of 20X1. The retailer has an unrestricted right of return during the first six months of 20X2, which is a departure from normal terms and conditions.
- (b) Offering a discount to a different retailer. The size of the discount offered depends on the value of goods that the retailer has purchased during 20X1. All remaining terms and conditions remain the same.

Issue

To what extent can the CPG company recognise revenue in 20X1?

Relevant guidance

Revenue from the sale of goods is recognised when all the following conditions have been satisfied [IAS 18.14]:

- The risks and rewards of ownership of the goods are transferred from the seller to the buyer;
- The entity retains no managerial involvement or control over the goods;

- The entity can measure the revenue reliably;
- Economic future benefits from the sale are probable; and
- The entity can measure the costs incurred in respect of the transaction reliably.

Revenue is measured at the fair value of the consideration received or receivable after taking into account discounts [IAS 18.10].

Solution

- (a) Revenue is recognised when all the necessary criteria are met, including reliable measurement of the revenue and the probable inflow of economic benefits. The CPG company does not recognise revenue until the right of return period expires or it is able to reliably estimate the level of returns, as this arrangement is a departure from the entity's normal trading terms.

The CPG company should not recognise revenue for this transaction in 20X1.

- (b) The arrangement provides the CPG company with the sale of goods at a lower margin. The company should recognise revenue when the goods are delivered, reduced by the discount and expected returns, provided the expected level of returns can be measured reliably.

12. Buy one get one free



Background

An entity manufactures chocolate and has a sales promotion campaign to attract new customers. During the campaign, customers are entitled to an offer of 'buy one get one free.' The sales price of one bar of chocolate is CU 5 and the production cost is CU 2.

Issue

How is a 'buy one get one free' transaction accounted for and presented?

Relevant guidance

'Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity...' [IAS 18.7].

Solution

Management records revenue of CU 5, being the amount received for the sale of the chocolate and cost of sale of CU 4. The purchase or production cost of a free product is a cost of sale, not a marketing cost.

13. Close-out fees



Background

A CPG company has decided to close out one of its product lines. As the company has a large quantity of the product in inventory, management reached an agreement with a major retailer to liquidate the stock.

The company will pay the retailer a 'close-out fee', which comprises 15% of the list price. The fee is payable when the product is purchased.

There is no right to return the products to the CPG company.

Issue

How should the CPG company account for close-out fees paid to a retailer?

Relevant guidance

Revenue is measured at the fair value of the consideration received or receivable. Trade discounts and volume rebates allowed by the entity should also be considered [IAS 18.10].

Solution

The CPG company should recognise revenue from the sale of the discontinued products net of the amount of the close-out fee that it paid to the retailer, as this is a bulk or trade discount [IAS 18.10]. The revenue should be recognised when the goods are delivered.

14. Pallet allowances



Background

A retailer buys a pallet of goods from one of its major suppliers. The retailer places the pallet directly on its store floor for display and sale of products to customers.

The retailer can offer reduced prices because customers serve themselves from the pallet. The CPG company gives a discount to the retailer justified by expectations of increased sales volumes and reduced packaging and handling costs.

Issue

How does a CPG company account for the pallet allowances given to a retailer?

Relevant guidance

Revenue is measured at the fair value of the consideration received or receivable. Trade discounts and volume rebates allowed by the entity are also considered [IAS 18.10].

Solution

The CPG company recognises revenue from the sale of the pallet of goods net of the amount of the discount given to the retailer.

15. Integrated value partner agreement



Background

An integrated value partnership agreement gives retailers an extra discount for purchasing a full truckload of goods. This agreement allows CPG companies to reduce the time and cost of delivery of goods to the premises of retailers.

CPG Company A offers an extra discount of 10% to retailers if they purchase a full truckload of goods. CPG Company A will therefore improve its distribution efficiency, reducing logistic costs.

Issue

How does CPG Company A account for the discount arising from the integrated value partnership agreement?

Relevant guidance

Revenue is measured at the fair value of the consideration received or receivable. Trade discounts and volume rebates allowed by the entity are also considered [IAS 18.10].

Solution

The CPG company recognises revenue from the sale of the full truckload of goods reduced by the amount of the discount given to retailers.

16. Co-advertising services



Background

Company D is a beverage producer and has entered into agreements with two of its customers (Retailer A and Retailer B) in relation to product advertisement.

Retailer A

Company D has entered into a joint advertising arrangement with Retailer A, under which advertisements are to be published in a local newspaper.

Company D has had arrangements in the past directly with the local newspaper and, absent the arrangement with the retailer, would advertise locally.

Retailer A will contract directly with the local newspaper and pay for the full cost of the campaign. Under a separate contractual arrangement with Retailer A, Company D has committed to reimburse 50% of the advertising costs. In order for Company D to reimburse Retailer A, it requires Retailer A to provide product placement and the associated proof of placement.

Retailer B

Company D also enters into a contract with Retailer B under which Retailer B is entitled to an advertising allowance of CU 10m if it displays Company D's goods on advertising boards in its stores with certain regularity throughout the year. Retailer B only provides the advertising on goods it purchases from its suppliers.

Issue

How should these transactions be presented?

Relevant guidance

Revenue '...is measured at the fair value of the consideration received or receivable' [IAS 18.10].

Consideration is to be given as to whether transactions are linked [IAS 18.13]. '*...the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.*'

Solution

Arrangement with Retailer A

In this arrangement, Retailer A is acting as a purchasing agent for Company D. The advertising payment to the retailer is validated by Company D previously purchasing similar advertising at similar pricing, and Company D could have entered into this arrangement regardless of whether or not Retailer A is a customer. Company D receives an identifiable benefit from the advertising that can be separated from the supply arrangements, and the fair value of the advertising services can be measured reliably. Given the combination of these factors, the advertising cost is separable from the supply relationship.

Retailer A would present the amount due from Company D as a receivable and as an offset to the gross advertising costs in the income statement. Company D would record the payment made as a marketing expense.

Arrangement with Retailer B

In this arrangement, Company D is unable to separate the arrangement from the underlying customer relationship and sales/purchase arrangement and therefore the amounts due by Company D to Retailer B would be recorded as a reduction of Company D's revenue. Retailer B would recognise the advertising allowance as a reduction of inventory value (and therefore as a reduction of cost of sales).

17. Retail markdown compensation



Background

Markdown compensation is an arrangement between a CPG company and a retailer under which the CPG company pays compensation to the retailer for markdown losses. The objective of the arrangement is for the CPG company to avoid the return of the goods from the retailer, which would be more costly than the payment of the compensation.

- (a) Company A is a well-established clothing producer. In order to prevent obsolete product accumulating in the distribution channel and to maintain relationships with the retailers, Company A has a well-established practice of providing retail-markdown compensation on outgoing collections two weeks before the launch of a new collection.
- (b) Company B is a newcomer to the coffee machine market. Its first model has been highly successful over the past three years but, as a result of the launch of the next model, Company B has decided to provide a retail-markdown compensation to eliminate the first model inventory from the retail channel. The second model will be sold directly through Company B's website.

Issue

How and when does the CPG company account for the markdown compensation that it grants to retailers in these two situations?

Relevant guidance

Revenue is measured at the fair value of the consideration received or receivable. Trade discounts and volume rebates allowed by the entity should also be considered [IAS 18.10].

Solution

In both cases, the CPG company should recognise revenue when the products are delivered. Revenue will be reduced by the amount of the markdown compensation it pays or expects to pay to the retailer. For Company A, the reduction is made at the time of shipment, as it has a well-established practice. Company B accrues the markdown expenses against revenue as soon as it has offered the discount, based upon the amount of inventory in the channel.

18. Scan deals



Background

Scan deals are agreements that involve a joint promotional campaign between CPG companies and retailers. The agreement specifies that CPG companies grant reduced prices to retailers who, at the same time, offer promotional prices to customers.

A CPG company and a retailer agree on a period of two months, during which all sales of a certain product will be subject to a special promotional price. The promotional period of two months will coincide with a media campaign for the products.

The CPG company does not have an established practice of scan deals.

The CPG company's normal selling price to the retailer is CU 80; the selling price from the retailer to the customers is CU 100. The CPG company and the retailer agree that both their respective prices will be reduced by 20%. The reductions in price apply only to goods sold in the promotional period.

The retailer reports unsold discounted products to the CPG company at the end of the promotional period and reimburses any unearned discount.

Issue

How does the CPG company account for the discount arising from scan deals?

Relevant guidance

Revenue is measured at the fair value of the consideration received or receivable after taking into account discounts [IAS 18.10].

Solution

For inventory shipped during or in preparation for the promotion, the CPG company recognises revenue when the products are delivered, reduced by the amount of the discount given to the retailer. The normal revenue of CU 80 per unit is reduced by the 20% discount to CU 64 per unit during the promotional campaign. A retrospective discount for inventory already held by the retailer that will be sold during the promotion, would also be adjusted against revenue.

19. Provision for returns from wholesalers/resellers



Background

Entity A is a shoe manufacturer that sells its product to a network of resellers. Entity A has no contractual obligation to take back products from its resellers but has an established practice of taking product back. Entity A has determined that 1% of goods are generally returned by the resellers and is obsolete on return.

Issue

Although there is no contractual obligation, how should Entity A account for the expected returns?

Relevant guidance

Revenue from the sale of goods is recognised when all the following conditions have been satisfied [IAS 18.14]:

- The risks and rewards of ownership of the goods are transferred from the seller to the buyer.
- The entity retains no managerial involvement or control over the goods.

- The entity can measure the revenue reliably.
- Economic future benefits from the sale are probable.
- The entity can measure the costs incurred in respect of the transaction reliably.

Retailers are considered to retain only an insignificant risk of ownership when refunds are offered to unsatisfied customers. Revenue is recognised at the time of sale provided the retailer can reliably estimate returns [IAS 18.17].

Solution

When there is a legal or constructive obligation to accept returns, revenue is recognised when the shoes are delivered and a provision deducted from revenue for expected returns based on historical data. Entity A therefore recognises a provision and reduces revenue for 1% of sales.

20. Slotting and listing fees



Background

Two similar arrangements between CPG companies and retailers are as follows:

- *Slotting fees:* Retailers give CPG companies the opportunity to have their products allocated to attractive/advantageous spaces in the retailers' premises for a defined period of time. The fee is generally fixed and independent of the volume of goods sold.
- *Listing fees:* CPG companies pay fees to the retailer in order to be included in the retailer's list of authorised CPG companies.

Issue

How do the retailers and CPG companies each present these transactions?

Relevant guidance

'It (revenue) is measured at the fair value of the consideration received or receivable' [IAS 18.10].

Consideration should be given as to whether transactions are linked [IAS 18.13]. *'... the recognition criteria are applied to two or more transactions together*

when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.'

Solution

Slotting fees and listing fees cannot usually be separated from the contract between CPG companies and retailers. Even if the two transactions are not linked, it will be difficult to determine the fair value of the listing and slotting fees.

The retailer recognises the consideration received for slotting and listing fees as a reduction of cost of sales (and therefore as a reduction of the inventory value).

The CPG company recognises the related expenses as a reduction of revenue.

21. Excise tax



Background

A CPG company manufactures beer and other alcoholic beverages. Excise tax legislation in Country X requires the entity to pay excise tax calculated as a percentage of the final sales price of the product. The tax is payable when the goods are dispatched to retailers. The excise tax is refundable if the retailers return or otherwise do not pay for the inventory.

Issue

How are excise taxes presented in the income statement of the manufacturer?

Relevant guidance

'Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity...' [IAS 18.7].

'Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes—are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue' [IAS 18.8].

Some factors that can be considered include:

- Risk and rewards: Is there a significant inventory risk after the excise tax is paid?
- Prices: Is the excise tax linked to the sales price of the product?
- Point of payment: Are the excise taxes paid close to production or close to the final sale of inventory?

Solution

In its income statement the CPG company would present revenue net of excise taxes. The excise tax is similar to a sales tax, and the entity is acting as an agent to collect it on behalf of the government.

The challenge concerning excise taxes is when an entity operates in multiple jurisdictions, where differing tax laws may result in some excise taxes generally being treated as deductions from sales and others as a cost of inventory. In these cases it might be possible, based on the materiality of the exceptions from the most common arrangement, for management to take a pragmatic and consistent approach to classifying excise taxes in the income statement as either gross or net.

US GAAP comment

ASC 605-45, 'Revenue Recognition—Principal Agent Considerations' provides guidance on the income statement classification of taxes assessed by a governmental authority.

Taxes within the scope of ASC 605-45 include any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer. It may include, but is not limited to, sales, use, value added, and some excise taxes. However, tax schemes that are based on gross receipts and taxes that are imposed during the inventory procurement process are not within the scope of ASC 605-45.

US GAAP, unlike IFRS, allows reporting taxes (within scope) on either a gross basis (included in revenues and costs) or a net basis (excluded from revenues) to be an accounting policy decision that should be disclosed in the financial statements. For any taxes that are reported on a gross basis, an entity discloses the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The disclosure of those taxes can be done on an aggregate basis.

Note: The accounting for excise taxes may be impacted by the new converged standard on revenue when issued.



Storage

22. Shrinkage



Background

A retailer experiences shrinkage through theft and other inventory loss. Experience shows that approximately 0.5% of all shelved inventory is subject to shrinkage.

Issue

How should the retailer account for shrinkage?

Relevant guidance

'Inventories shall be measured at the lower of cost and net realisable value' [IAS 2.9].

Solution

Shrinkage is accounted for as a cost of sale. Inventory quantities are reduced to reflect an estimate of the shrinkage that will have occurred since the last stock-take.

23. Warehouse costs



Background

A retailer purchases finished goods and stores them in a warehouse before delivery to its retail stores. The retailer transfers finished goods between internal warehouses and retail stores, incurring related transportation costs.

The retailer incurs storage costs for the warehouse, such as rental, depreciation and utilities.

Issue

- (a) Should these costs be included in inventory or expensed as incurred?
- (b) How should the retailer account for intermediate warehouse costs?
- (c) How should the retailer account for the intermediate transportation costs between different internal warehouses and from the internal warehouses to its retail stores?

Relevant guidance

The cost of inventories includes the cost of all materials that enter directly into production and the cost of converting those materials into finished goods. The direct materials costs include, in addition to the purchase price, all other costs necessary to bring them to their existing condition and location. [IAS 2.10].

Examples of costs excluded from the cost of inventories and recognised as expenses in the period incurred are:

- *Abnormal amounts of wasted materials, labor or other production costs;*

- *Storage costs, unless those costs are necessary in the production process before a further production stage;*
- *Administrative overheads that do not contribute to bringing inventories to their present location and condition; and*
- *Selling costs*' [IAS 2.16].

Solution

Intermediate storage costs, transportation costs between internal warehouses and transportation costs to the retail stores represent an unavoidable part of the supply chain in getting inventories to their present location and condition and are generally included in the cost of inventory. They are part of the normal business model and are incurred to get the inventories to their first point of sale.

US GAAP comment

The IFRS approach is acceptable under US GAAP, but practice varies, which may lead to differences between US GAAP and IFRS reporters.

'Back store' storage or costs related to warehouses located next to a store are not included in the cost of inventory, as these costs are not incurred to get the inventory to its present location and condition.

Individual facts and circumstances determine which costs are included in the cost of inventory.



Property and leases

24. Rent-free periods



Background

A retailer enters a lease agreement for a new store.

The agreement is for five years and does not include an option to buy the property. The retailer will not have to make any payments during the first year of the lease term, but will make monthly payments of CU 100,000 from the second year onwards.

The agreement grants the retailer an option to renew the lease for an unlimited number of further periods of five years.

The retailer has incurred significant expenditure to tailor the premises to its branding standards and has waited for premises in this area for some time. Management is reasonably certain at inception of the lease that it will exercise the option. However, it is not reasonably certain that the lessee will remain in the premises for more than 10 years.

Issue

How should the retailer account for the rent-free periods in lease agreements?

Does the intention to renew an agreement affect the allocation of the rental expenses?

Relevant guidance

Lease payments under an operating lease are recognised as an expense in the income statement on a straight-line basis over the lease term unless the time pattern of the user's benefit is better represented by another basis [IAS 17.33].

The lease term is the non-cancellable period for which the asset is leased, together with any further terms for which there is an option to continue to lease the asset, with or without further payment, and that option is, at the inception of the lease, reasonably certain to be exercised [IAS 17.4].

Solution

The retailer includes the rent-free period in the calculation and presentation of the lease payments over the whole lease term as the rent-free period is an integral part of the rental agreement.

The lease term should be considered to be 10 years, because management is reasonably certain at the inception of the lease that the lessee will exercise the first renewal option.

Rental expense, including the rent-free period, would be recognised in the income statement on a straight-line basis over the lease term of 10 years.

Note: The treatment and recognition of lease payments and incentives may be significantly impacted by the new converged standard on leases when issued.

25. Treatment of lease advance payments



Background

A retailer enters new long-term lease agreements for three stores.

The stores are in prime locations, and the retailer has made advance payments to the landlords as follows:

- *Building A: finance lease.* The advance payments were paid to the lessor.
- *Building B: operating lease.* The advance payments were paid to the lessor.
- *Building C: operating lease.* An interest-free rental deposit was paid by the retailer to the lessor. The deposit is refunded at the end of the lease term.

Issue

How should management of the retailer account for the advance payments and interest-free deposit paid to the landlords?

Relevant guidance

Minimum lease payments are the payments over the lease term that the lessee makes, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee [IAS 17.4].

'Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the user's benefit' [IAS 17.33].

'When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at

fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability' [IAS 39.43].

After initial recognition, loans and receivables are measured at amortised cost using the effective interest method [IAS 39.46].

Solution

Building A—Management includes the advance payment in the present value of the minimum lease payments.

Building B—Management defers the advance payment as prepaid rent and amortises it over the lease term on a straight-line basis.

Building C—The interest-free deposit is a financial asset. It is recorded at its fair value, which is below face value. The resulting discount is included in calculating initial direct costs and amortised over the lease term. The accretion of interest on the deposit is interest income.

US GAAP comment

The IFRS approaches for Buildings A and B would be acceptable under US GAAP. The IFRS approach for Building C is also acceptable under US GAAP; however, the more common approach would have the full payment treated as a minimum lease payment at the beginning of the lease, with the refund being treated as a negative minimum lease payment at the end of the lease.

Note: The treatment and recognition of lease payments and incentives may be significantly impacted by the new converged standard on leases when issued.

26. Key money



Background

A retailer entered new long-term lease agreements for two stores—one in Paris, one in Zurich.

The stores are in prime locations and the retailer has paid amounts to the incumbent tenants to obtain the leases. Management's explanation of the magnitude of the amounts paid differs according to location.

- *Paris store:* The landlords' powers in France are restricted. Landlords are limited in their ability to increase rents beyond nominal amounts even at the break of a lease, and they are unable to evict tenants without compensation.

The 'key money' represents the difference between current rents and fair market rent for a similar property without the restrictions, plus an additional premium paid to obtain the site ahead of a competitor. The retailer has rights to renew the lease in the future and expects to be able to recover at least the original investment from the tenant who takes over the lease when it moves out.

- *Zurich store:* The original lease was for 10 years, but only five have expired. There are no rent increases built into the lease. However, at the lease break, the landlord is able to bring new rents back in line with market rates. Demand for rental property in this area of the city has significantly increased in the last five years.

Issue

How should the retailer account for the amounts paid to an incumbent tenant in an operating lease?

Relevant guidance

A company looking to move to a sought-after retail location may make payments to an incumbent tenant in order to take over the lease. There may be many reasons for such a payment, and management needs to understand the economics behind the payments in order to correctly account for them.

These payments to the incumbent tenants (often referred to as 'key money') will generally be classified as an intangible asset and accounted for under IAS 38, 'Intangible Assets.'

If payment had been made to the landlord, instead of the incumbent tenant, it would generally be included in the minimum lease payments of the lease arrangement and accounted for under the lease accounting guidance in IAS 17, 'Leases' (US GAAP: ASC 840, 'Leases').

Solution

Paris—The retailer would capitalise the key money as an intangible asset and amortise over the estimated remaining life of the premises given the right to renew the lease. If, giving careful consideration to the useful life of the underlying premises, management concludes that the key money has an indefinite life, it should not be amortised but tested for impairment annually.

Zurich—The retailer would capitalise the key money and amortise over the remaining term of the lease (five years).

The treatment of key money is not affected by the lease classification.

27. Contingent rental payments



Background

A real estate entity builds a new shopping centre.

Retailer A enters a lease with the real estate entity.

The lease agreement requires A to pay rent equal to:

- (a) 3% of each month's sales subject to a minimum payment of CU 200 per month; plus
- (b) an additional 1% of annual sales if annual sales exceed CU 1,500,000.

Sales in the first six months amount to CU 1,200,000.

The budget for the full year is CU 2,500,000.

Issue

Does Retailer A include contingent rental payments in the calculation of minimum lease payments?

Does Retailer A account for the expected contingent rent payments at the year end and in interim financial statements?

Relevant guidance

Contingent rent is the portion of the lease payments that is based on a factor other than just the passage of time. Examples of contingent rent are percentage of sales, amount of usage and price indices [IAS 17.4].

'Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, cost for services and taxes to be paid by and reimbursed to the lessor' [IAS 17.4].

Solution

Contingent rentals are excluded from the calculation of minimum lease payments. However the minimum rental payments of CU 200 per month are included in the minimum lease payments.

Retailer A should recognise the rental expense each month based on that month's sales and its best estimate of the percentage of sales that will be paid. The incremental rent triggered when monthly sales exceed CU 6,667 (CU 6,667 = 200/3%*) is contingent rent and should be recognised as an expense when incurred.

**When preparing the interim financial statements, rent for the entire period is estimated based on management's best estimate of whether it will pay 3% or 4% of sales as rental.*

US GAAP comment

As with IFRS, contingent rentals are excluded from the calculation of minimum lease payments.

US GAAP does not prescribe how the liability for progress toward the target should be recognised.

Note: The treatment and recognition of contingent lease payments may be impacted by the new converged standard on leases when issued.

28. Impairment of stores to be closed



Background

A retailer owns several stores in Europe. One of the stores has been making losses for the last three years. Management has plans to close it in six months, after a liquidation sale period. Management has prepared and approved a formal plan to close the store with a commitment not to change it. It has also started an active search for a buyer of the store's assets.

Issue

How does management treat a store that will be closed because of poor performance?

Relevant guidance

Whenever there is an indication of impairment, the entity estimates the recoverable amount of the asset [IAS 36.9] and records an impairment if lower than the carrying amount.

The approval and announcement of a plan to discontinue or restructure operations is an indication that the assets attributable to the discontinuing operation may be impaired [IAS 36.12(f)].

Immediately before classifying a disposal group as held for sale, the carrying amounts of the assets and liabilities within the group are measured in accordance with the applicable IFRS [IFRS 5.18].

Solution

The store is a separate cash-generating unit. Management tests the store for impairment when the decision to close is taken or where there is an indication of impairment, with the carrying value being impaired if required. Management will also need to evaluate the remaining useful economic life of the store.

US GAAP comment

There is a different definition in US GAAP of the 'asset group' versus CGU in IFRS. If the company historically determines that the store level was the lowest level of identifiable and independent cash flows, the approval of the formal plan would be a triggering event. The store is therefore tested for impairment under ASC 360, 'Property, Plant and Equipment.' Management's probable plans of disposal should be considered in estimating future cash flows.

29. Determining CGUs for multi-site retailers



Background

A retail store chain owns many stores both domestic and international. The stores are generally located in different neighbourhoods or airports; however, Stores X and Y are located in the same neighbourhood. All retail purchases, pricing, marketing, advertising and human resource policies (except for hiring of individual store cashiers and sales staff) are performed for all stores centrally. In addition, the products sold by each store are the same.

Issue

Should Stores X and Y be combined for impairment testing purposes?

Relevant guidance

A CGU is defined as the *'smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets'* [IAS 36.6].

IAS 36 Basis for Conclusions (Example 1) considers CGUs for a chain retailer with multiple stores in the same city, although based in different neighbourhoods, and concludes that the CGU is at a store level.

An IFRS Interpretations Committee Agenda Decision in March 2007 states that 'independent cash inflow' in IAS 36 does not mean net cash flow. Cash outflows are therefore not taken into consideration in the analysis.

Solution

In the majority of circumstances, conventional retail stores would be separate CGUs as each store generates cash inflows that are independent of other stores in the chain. This is consistent with the example in IAS 36. The fact that costs are incurred centrally is not relevant.

US GAAP comment

Clustering of stores for impairment testing purposes is possible under ASC 360, 'Property, Plant and Equipment.' For example, if it is determined that customers would frequent either Store X or Y then those stores may be grouped together as the cash flows are not independent of one another. That is, for example, if one store were to close, customers that frequented the closed store would now shop at the remaining open store.

30. Flagship stores



Background

A luxury retailer has opened a new flagship store in a prime site location in New York.

The costs incurred in the development of the store were significant. These costs, combined with the high rent on the property given its location, mean that management expects the flagship store to make a loss from the outset.

In its first year of operation, the flagship store is loss making, although its commercial performance is in line with original expectations.

Issue

Should the flagship store be tested for impairment?

Relevant guidance

An entity needs to assess at the end of each reporting period whether there is any indication that an asset may be impaired. Only if such an indication exists is the entity required to perform an impairment review, and in doing so estimate the recoverable amount of the asset [IAS 36.9].

In assessing whether there is an indication that an asset may be impaired, entities should consider, among other things, whether there is evidence to indicate that the economic performance of the asset is, or will be, worse than expected [IAS 36.12(g)].

Solution

On the basis that the flagship store is performing in line with original expectations, it could be argued that there is no indication that the store might be impaired and therefore no impairment test is required.

If in subsequent years the flagship store makes losses in excess of those originally anticipated, this could be a trigger for an impairment test to be performed.

US GAAP comment

Clustering of stores for impairment testing purposes is possible under ASC 360, 'Property, Plant and Equipment', and in some situations the flagship store would be aggregated with other retail stores for impairment testing purposes.

Alternatively, if the flagship store is deemed to benefit all of the retailer's other stores (for example advertising the store brand, marketing, etc.), it may be appropriate to consider the cost of operating the flagship store as part of corporate costs and allocate these to other asset groupings for impairment testing.

31. Cash flows relating to Internet-based sales



Background

A retailer operates a chain of more than 100 'traditional' retail stores which are geographically dispersed.

The retailer also provides its customers with an Internet offering, which has been growing in recent years, where product can be ordered online and delivered to their home or collected from a store of the customer's choice. Where the Internet sales are delivered to the customer's home they could be sourced either from the retailer's central distribution center or from an individual store.

Issue

How should the cash inflows from Internet sales be treated in relation to the assessment of impairment at the retailer's 'bricks and mortar' stores?

Relevant guidance

A CGU is defined as the '*smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets*' [IAS 36.6].

Solution

The inclusion of cash inflows from Internet-based sales in the impairment assessment of retail stores will depend on whether the Internet sale can be specifically allocated to a particular store.

For example, in the case where an Internet order is sourced from a store or is shipped to and picked up by the customer from a store, the sale can be allocated to the particular store and hence the inclusion of the cash inflows from the sale may be appropriate for the purposes of the impairment test.

In the case where Internet sales are sourced from a central warehouse, the cash inflows are independent of the retail store and therefore should be excluded from the store's impairment assessment.

US GAAP comment

Clustering of stores for impairment testing purposes is possible under ASC 360, 'Property, Plant and Equipment', and in some situations cash flows from Internet sales could be aggregated with other retail stores for impairment testing purposes. This will be on a case-by-case basis and will be dependent on the individual facts and circumstances and the relationship between the stores and the Internet operations.

32. Allocation of rebates to CGUs



Background

Group A is a retailer that sells food in its stores throughout the country. Management purchases the food centrally and obtains a 10% discount for large volumes purchased.

Each store would not get such a discount if it purchased the food separately.

Each store is a separate cash-generating unit.

Issue

Does management allocate the rebates received at head office to cash-generating units for impairment-testing purposes?

Relevant guidance

The carrying amount of a cash-generating unit [IAS 36.76]:

- (a) includes the carrying amount of only those assets that are directly attributable, or can be allocated on a reasonable basis, to the cash-generating unit; and
- (b) does not include the carrying amount of any recognised liability, unless it is not possible to determine the recoverable amount without this liability.

Solution

Management should allocate the rebates to the cash flows of each store on a reasonable and consistent basis to reflect the rebates relevant to each CGU.

33. Pre-opening costs



Background

A chain of supermarkets has acquired and now owns a new store. The new store requires significant expenditure to renovate the premises.

Management expects the renovations to take three months, during which the supermarket will be closed. Management has prepared the budget for this period including expenditure related to construction and remodeling costs, retail salaries of staff who will be preparing the store before its opening and related utilities costs.

Issue

Which costs incurred prior to the opening of the store should be capitalised?

Relevant guidance

The cost of an item of property, plant and equipment includes directly attributable expenditure necessary to bring the asset to the location and condition necessary to operate in the manner intended by management [IAS 16.16(b)]. These include external costs, such as delivery and installation costs, architects' fees and import duties.

Internal costs to be capitalised include directly-attributable overhead costs where applicable. Overhead costs relating to unproductive or inefficient use of resources are expensed as incurred.

General administrative costs not directly attributable to acquiring, constructing or commissioning the asset are also expensed as incurred [IAS 16.19, 20].

Solution

The costs of constructing and remodelling the supermarket are capitalised, because they are required to bring the store to the condition necessary for it to operate in the manner intended by management. The supermarket cannot be opened without making the remodelling expenditure; the expenditure is part of the asset.

The cost of retail salaries, utilities and storage of goods are operating expenditures that would be incurred if the supermarket was open. These costs are not necessary to bring the store to the condition necessary for it to operate in the manner intended by management. They are expensed as incurred.

34. Make-good provisions



Background

Entity X leases several stores for 10 years with options to extend the leases. The leases require the stores to be restored to their original condition at the end of the lease terms, even if the lease is terminated early—i.e., repair all damages and remedy any alterations made to the premises.

History shows the following:

- (a) Entity X often renews its leases at the end of the option period.
- (b) Entity X negotiates with the landlord or future tenant and avoids the dilapidation costs.
- (c) Entity X pays the full costs of making good only in a minority of cases.

Issue

When should management recognise a provision for the obligation to restore the leased property to its original condition?

Relevant guidance

The cost of an item of property, plant and equipment comprises:

- (a) its purchase price;
- (b) any costs directly attributable to bringing the asset to its operating location and condition; and
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located [IAS 16.16].

A provision shall be recognised when:

- (a) *an entity has a present obligation (legal or constructive) as a result of a past event;*
- (b) *it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.*

(c) *a reliable estimate can be made of the amount of the obligation.*

If these conditions are not met, no provision shall be recognised' [IAS 37.14].

Solution

An asset that is added to the leased premises that must be removed at the end of the lease—In this case, the cost of removing the asset is added to the asset value (and amortised over the life of the asset) and recognised as a provision.

Damage to the property that must be repaired at the end of the lease—In this case, a liability is recognised as the damage is incurred over the period.

Management cannot avoid providing for the make-good costs where a contractual commitment exists, because it has a history of renewal of leases. However, the renewal of leases will impact the measurement of the liability at present value. Management's intention (and especially intention to stay at the premises for a long period of time) should be taken into consideration in measuring and discounting the liability. When management's intentions change, the measurement should be revisited.

US GAAP comment

The solution under US GAAP requires judgment, as the accounting treatment of the make-good provision would depend on the nature of the restoration. If the provision consists of restoring the premises to the original conditions as they were at the inception of the lease term (repair all damages and remedy all alterations made to the premises), the obligation may fall under the scope of ASC 840, 'Leases', and the restoration costs could be defined as a minimum lease payment. If the restoration means removing any leasehold improvements constructed by the lessee during the lease term, the provision would fall under ASC 410-20. Under ASC 410-20, 'Asset Retirement Obligations', an entity recognises the fair value of a liability for an asset retirement obligation in the period it is incurred if a reasonable estimate of fair value can be made.

35. Properties with mixed use— sub-letting of retail space



Background

A retailer owns a property that it partially uses for its own operations as a supermarket, but some separate shops are sub-leased to other entities on a long-term basis.

Management wishes to treat the portion of the building that is sub-let as an investment property.

Issue

Can the retailer treat the sub-leased areas as investment property?

Relevant guidance

'Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.' [IAS 40.10].

Solution

The areas that are designated by the retailer to be sub-let are clearly identifiable and separate from the area used by the retailer. The existence of long-term rental contracts for the location confirms that the area should be classified as investment property.

US GAAP comment

US GAAP does not contain a specific definition or guidance for investment property. For entities that are not investment companies, such property is accounted for in the same way as property, plant, and equipment (PPE). In addition, US GAAP also does not contain guidance on how to classify dual-use property. Instead, the entire property is accounted for as PPE.

Note: The treatment and recognition of sub-let transactions may be impacted by the new converged standard on leases when issued. In addition, the US GAAP treatment may be impacted by the FASB project on investment properties.

36. Favourable and unfavourable lease contracts in a business combination



Background

Retailer A acquired Company B in a business combination. Company B operated a number of retail locations that were leased.

Each retail location has leasehold improvements.

In comparison to current market rates, Retailer A deems some of the lease contracts to be favourable, and some to be unfavourable.

Issue

How does management reflect the lease contracts and leasehold improvements in the purchase price allocation?

Relevant guidance

Intangible assets or liabilities may be recognised for certain contracts, such as lease arrangements, whose terms are favourable or unfavourable to current market terms. In making this assessment, the terms of a contract should be compared to market prices at the date of acquisition to determine whether an intangible asset or liability should be recognised. If the terms of an acquired contract are favourable relative to market prices, an intangible asset is recognised. On the other hand, if the terms of the acquired contract are unfavourable relative to market prices, then a liability is recognised [IFRS3R.B29].

Each arrangement is recognised and measured separately. The resulting amounts for favourable and unfavourable contracts are not offset.

Solution

The fair value of an intangible asset or liability associated with favourable and unfavourable contract terms would generally be determined based on present value techniques, and would be amortised/recognised over the remaining contract term, including renewals, if applicable.

Operating leases—An intangible asset or liability shall be recognised if the acquiree is the lessee in an operating lease and the rental rates for the lease contract are favourable or unfavourable compared to market terms of leases for the same or similar items at the acquisition date. Leasehold improvements of the acquired entity would be recognised as tangible assets on the acquisition date at their fair value.

Finance leases—No separate intangible asset or liability would typically be recognised for the lease contract terms if the acquiree is a lessee in a finance lease. Any value inherent in the lease (i.e., fair value associated with favourable or unfavourable rental rents, renewal or purchase options), is typically reflected in the amount assigned to the finance lease asset and the finance lease obligation.

Note: The treatment of leases in a business combination may be impacted by the new converged standard on leases when issued.



Sales and marketing

37. Distributor acting as an agent



Background

A department store contains concession outlets. The store provides the concessionaire with serviced space in the store, sales staff, point of sale equipment and stock-room space. The concessionaire pays the department store a fixed contractual fee of CU 10,000 per annum plus 20% of the outlet's revenue.

The concessionaire determines the stock lines sold and the prices charged to customers and has the right to move stock between its concessions in different stores. At the end of a season, the concessionaire must take back any unsold stock.

Issue

How does the department store account for this arrangement?

Relevant guidance

'... in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead revenue is the amount of commission' [IAS 18.8].

Whether an entity is acting as a principal or an agent in transactions depends on the facts and circumstances of the relationship.

Indicators that an entity is acting as a principal in transactions include:

- The customer expects that the entity is acting as the primary obligor in the arrangement.
- The entity is able to set the selling price with the customer.
- The entity has inventory risk.
- The entity performs part of the services provided or modifies the goods supplied.
- The entity has or assumes the credit risk associated with the transaction.

Solution

The department store is acting as agent in selling to the customer and is receiving a 'commission' in consideration for the service that it is performing for the concessionaire (making available space in the department store).

The department store has no influence over the price, does not modify the goods and bears minimal credit risk. The department store is able to return the goods at the end of each season, which means the concessionaire bears the product and inventory risks.

The department store recognises the 'commission' receivable from the concessionaire as revenue, rather than the gross revenue of the concession.

38. Right of return in exchange for cash



Background

A retailer sells T-shirts. Customers can return the shirts within 28 days of purchase. Returns will only be accepted with proof of purchase and if the T-shirts are unused and saleable as new. Historically 10% of the retailer's sales are returned by customers; this rate is expected to continue. History has shown that all returns come back undamaged and can be resold at full price. The margin on the T-shirts is 50%.

The retailer has several outlets in different areas. Each outlet will accept returned goods, subject to the above conditions, in exchange for cash.

Issue

How does a retailer recognise revenue on the sale of goods when a right of return is provided in exchange for cash?

Relevant guidance

Revenue from the sale of goods is recognised when all the following conditions have been satisfied [IAS 18.14]:

- the risks and rewards of ownership of the goods are transferred from the seller to the buyer;
- the entity retains no managerial involvement or control over the goods;
- the entity can measure the revenue reliably;
- probable economic future benefits will flow to the entity; and
- the entity can measure the costs incurred in respect of the transaction reliably.

Solution

The retailer has an accounting policy choice:

- (a) The retailer recognises revenue on the sale of the goods, with a 10% adjustment to revenue (through the recording of a provision) to reflect the risk of returns. The recognition of revenue and the provision for returns is made when the sale is made.

Inventory is increased with a corresponding reduction to cost of sales when the customer returns the goods. The provision is reduced by the cash paid; or

- (b) The retailer recognises a 10% adjustment to revenue for the risk of return when the sales are made, with a corresponding adjustment to cost of sales representing the expected value of the corresponding goods to be returned. The net amount, which essentially represents the margin on the sale, would be recognised as a provision for returns.

Note: The treatment and recognition of rights of return may be impacted by the new converged standard on revenue when issued.

39. Discount coupons



Background

A clothing retailer has launched a promotional campaign. The campaign has two different elements to it:

1. A coupon is published in a national newspaper giving a discount of 5% off any purchase over CU 50 in any of the retailer's stores.

The retailer's normal gross margin on sales is 60%. The coupons are not therefore an onerous contract.
2. The retailer distributes a series of coupons granting customers a free item with a retail value of CU 10 when they have purchased a specified item of clothing with a retail value of CU 100.

Issue

How does the retailer account for these discount coupons?

Relevant guidance

Revenue is the gross inflow of economic benefits during the period that is generated in the course of the ordinary activities of an entity. Those inflows should result in increases in equity, other than increases relating to contributions from equity participants [IAS 18.7].

Solution

Discount coupons—The retailer does not recognise a liability in its financial statements for the distribution of coupons. It treats the coupons as discounts against revenue when the customers redeem them.

The coupon encourages the customers to spend, rather than being a cost of promoting the stores. The cost of placing the newspaper advertisement is expensed when the newspaper is published.

Free item—The retailer does not recognise any provision when it distributes the coupons. It treats the costs related to the coupons as a cost of sales when customers redeem them.

The coupon encourages customers to make purchases and thus leads to revenue generation. The cost of the free item is a cost of sales and not a marketing cost, the same as 'buy one, get one free' offers.

40. Revenue from sale of gift vouchers



Background

A book retailer has launched a campaign of gift vouchers for the Christmas season.

The gift vouchers are sold by the bookstores at face value. The gift vouchers have no alternative use. Customers are able to exchange vouchers for any book in the store. The gift vouchers do not have an expiry date.

The customer has to pay the balance in cash if the price of the book purchased exceeds the face value of the voucher. The store does not refund cash if the value of the voucher exceeds the value of the book.

Issue

Does the retailer:

- (a) recognise revenue on the sale of gift vouchers?
- (b) recognise revenue for vouchers that remain unredeemed for an extended period?

Relevant guidance

Revenue from the sale of goods is recognised when all the following conditions have been satisfied [IAS 18.14]:

- (a) the risks and rewards of ownership of the goods are transferred from the seller to the buyer;
- (b) the entity retains no managerial involvement or control over the goods;
- (c) the entity can measure the revenue reliably;
- (d) probable economic future benefits will flow to the entity; and
- (e) the entity can measure the costs incurred in respect of the transaction reliably.

Solution

- (a) No revenue is recognised when the voucher is sold. The retailer recognises revenue only when customers redeem the vouchers for a book. The revenue recognition criteria are met when the holder of the voucher exchanges the voucher and takes ownership of the book.

Deferred revenue for an amount equal to the face value of the gift vouchers is recognised when the gift vouchers are sold.

- (b) Retailers may retain the benefit from unredeemed vouchers only when customers use the vouchers or after a certain period of time based on:
 - the specific facts and circumstances (including market practices and legal rights);
 - a strong historic base that allows an entity to determine when it becomes remote that a voucher will be redeemed.

Estimates are readjusted as necessary based on movements in the actual redemption patterns.

The solution excludes gift vouchers that are distributed as part of a loyalty programme. These vouchers are treated under IFRIC 13. (See Solution 41)

41. Customer loyalty programmes



Background

A grocery retailer operates a customer loyalty programme, granting members loyalty points when they spend specific amounts on groceries. The points accumulated can be redeemed for future purchases at the retailer.

In year one, the grocer makes sales of CU 1,000 and issues 100 award points. Management expects 80 award points to be redeemed. The fair value of each loyalty point is estimated to be CU 1.25.

Issue

How does the retailer account for the loyalty award points?

Relevant guidance

Loyalty programmes are a multiple element arrangement, under IFRIC 13, 'Customer Loyalty Programmes.' The consideration received for the sale of goods (from which award credits are earned) is allocated to the goods delivered and the award credits that will be redeemed in the future (IFRIC 13.5).

The consideration allocated to the award credits is measured by reference to their fair value to the customer (IFRIC 13.6).

The amount at which they could be sold separately is reduced in proportion to the award credits that are not expected to be redeemed. It is also permissible to use the relative fair value—being the fair value of the awards relative to the fair value of the other components of the sale.

The consideration allocated to award credits is presented as 'deferred revenue' in the balance sheet. Such revenue is recorded in the income statement on redemption of the awards.

Solution

At the end of year one, the retailer defers an amount either based on fair value per point or relative fair value of the award points. These are calculated as follows:

(a) Deferred revenue (fair value) =

$$\begin{array}{rccccccc} & \text{number} & & \text{x} & \text{redemption} & & \text{x} & \text{fair value} \\ & \text{of loyalty} & & & \text{rate} & & & \text{per point} \\ & \text{points} & & & & & & \\ = & 100 \text{ pts} & & \text{x} & 80\% & & \text{x} & 1.25 = 100 \end{array}$$

(b) Deferred revenue (relative fair value) =

$$\begin{array}{l} \text{(total consideration x fair value of award points) /} \\ \text{(total consideration + fair value of award points)} \\ = (1,000 \times 100) / (1,000 + 100) = 91 \end{array}$$

The amount of revenue recognised in the following year is based on the number of points redeemed, relative to the total number expected to be redeemed. The release is accelerated or decelerated prospectively, as the redemption estimates are amended to reflect historical experience.

US GAAP comment

It is acceptable to account for loyalty programmes as multiple-element arrangements using an analogy to ASC 605-25, 'Revenue Recognition Multiple-Element Arrangements.' In multiple-element arrangements breakage cannot be assumed when determining the fair value of the award. Therefore in the example above, the redemption rate would not be considered. Additionally, the incremental cost model may be appropriate in certain circumstances, when the costs of fulfilling liabilities arising from such programmes are inconsequential or perfunctory.

Note: The accounting for customer loyalty programmes may be impacted by the new converged standard on revenue when issued.

42. Exceptions to point-of-sale advertising



Background

A retailer links certain promotional materials to the sale of a product in the following ways:

- Selling pre-packed displays of regular product to include some promotional material.
- Linking the promotional items or gift to the sale of a regular product in the form of an offer.

Issue

Can the costs of the promotional materials linked to the sale of product be expensed when that product is sold?

Relevant guidance

As noted in solution 7, in normal circumstances advertising and promotional expenditure is recognised as expensed as incurred, but IFRS does not preclude recognising a prepayment when payment for the goods or services has been made in advance of the delivery of goods and rendering of services [IAS 38.68-70].

Revenue is the gross inflow of economic benefits during the period that is generated in the course of the ordinary activities of an entity [IAS 18.7].

Solution

The solution depends on the type of promotional material.

If it is product that would normally be sold (e.g., a fabric conditioner being promoted with the sale of washing tablets) the promotional materials are linked to the sale of a product such that the customer is purchasing both the regular product and the promotional material together. The revenue therefore reflects the sales value of both the regular product and promotional material.

Accordingly, it would be appropriate for the costs of the promotional materials to be expensed at the same time as the sale.

If the promotional product is true marketing product (e.g., a cuddly toy being linked to the sale of cosmetics) then the costs of the promotional product should be expensed as title is taken.

US GAAP comment

Generally under US GAAP costs of promotional material would be deferred until the point that they are provided to the customer which, in the case of marketing products, may be at a later point than under IFRS.

43. Extended warranties



Background

A retailer sells electrical goods that come with a manufacturer's one-year warranty. The retailer also offers customers the option of purchasing an extended warranty to cover a further three years after the expiry of the manufacturer's warranty.

The sales price of the extended warranty is CU 120. The retailer typically receives valid warranty claims from 3% of customers during the extended warranty period.

The average cost of repairing or replacing the goods under the warranty is CU 400 per valid claim.

Issue

How should this arrangement be accounted for by the retailer?

Relevant guidance

'Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses. Expenses, including warranties and other costs to be incurred after the shipment of the goods, can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied. However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability' [IAS 18.19].

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction is recognised by reference to the transaction's stage of completion at the balance sheet date [IAS 18.20].

Solution

The revenue associated with the extended warranty is deferred and recognised on a straight-line basis over the period for which the extended warranty service is provided (unless there is evidence that some other method better represents the stage of completion). Annual revenue of CU 40 is recognised each year.

In instances where the extended warranty is an integral part of the sale (i.e., bundled into a single transaction), revenue should be allocated between the product and extended warranty on a relative fair value basis. The costs incurred to fulfill the warranty obligation are charged to cost of sales as incurred.

A provision is not recognised for the expected costs of meeting the warranty obligation. The arrangement is monitored to ensure that the expected cost of the warranty does not exceed the amount of deferred revenue. If this occurs, the warranty contract will be onerous, and a provision is recognised.

US GAAP comment

ASC 605-20, 'Revenue Recognition-Services', addresses the accounting for separately-priced extended warranty and product maintenance contracts. It is usually different from IFRS where the extended warranty is bundled with the underlying product in that it requires the deferral of revenue generated by the separately-priced extended warranty determined by reference to the stand-alone selling price for maintenance contracts.

Note: The accounting for extended warranties may be impacted by the new converged standard on revenue when issued.

44. Credit card fees



Background

A retailer receives payment from its final customers by different means, including cash, bank cheque and credit card. In the case of credit card payments, the retailer's bank will apply a fixed percentage fee on each transaction to deliver the money to the retailer's bank account.

Issue

How does the retailer account for the sales by credit card and, in particular, the fee paid to the bank in order to recover customer payment made by credit cards?

Relevant guidance

'It (revenue) is measured at the fair value of the consideration received or receivable' [IAS 18.9].

'...in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead revenue is the amount of commission' [IAS 18.8].

Whether an entity is acting as a principal or an agent in transactions depends on the facts and circumstances of the relationship.

IAS 18 IE.21 provides the following guidance:

'An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include:

- (a) the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order—for example by being responsible for the acceptability of the products or services ordered or purchased by the customer;*
- (b) the entity has inventory risk before or after the customer order, during shipping or on return;*
- (c) the entity has latitude in establishing prices, either directly or indirectly—for example by providing additional goods or services; and*
- (d) the entity bears the customer's credit risk for the amount receivable from the customer.'*

Solution

The bank is acting as agent on behalf of the retailer, as the retailer has the inventory risk and sets the selling price. The bank collects the cash from the final customer and delivers this cash to the retailer net of its fixed commission. The bank bears the credit risk associated with the transaction, but this does not change the accounting.

The retailer is acting as principal, and the sales are recognised gross. The fee to the bank is an expense. This mirrors the accounting treatment for the bank as the agent which recognises only the fixed commission on each sale as revenue. Additional fees levied that might, for example, reflect a mechanism to provide interest-free credit to the customer would typically be deducted from revenue.

A chef in a white uniform and apron is talking on a mobile phone while holding a clipboard. He is standing in a commercial kitchen next to a tall metal rack filled with trays of baked goods. The chef is bald with a beard and is wearing a watch on his left wrist. The kitchen has stainless steel walls and a large metal door in the background.

Inventory

45. Retail inventory method



Background

A retailer values inventory using the retail inventory method. The application of the inventory method is different for Retail Department A and Retail Department B as follows:

Retail Department A: The cost/retail value ratio used to calculate the value of inventory is based on the gross margin earned in the previous four weeks and therefore incorporates permanent markdowns.

Original inventory cost	60	Cost/retail value ratio for previous 4 weeks	67%
Original retail value	100	Current retail value	90

Using their retail inventory method, Department A values inventory at CU 60 (current retail value x 67%).

Retail Department B: The cost/retail value ratio used to calculate the value of inventory is based on the original cost/retail value ratio and therefore excludes additional permanent markdowns made from the original purchase (this methodology is otherwise known as the conventional retail inventory method).

Original inventory cost	60	Cost/retail value ratio for previous 4 weeks	60%
Original retail value	100	Current retail value	90

Using their retail inventory method, Department B values inventory at 54 (current retail value x 60%).

Issue

Are the different methods of application of the retail inventory method appropriate under IFRS?

Relevant guidance

Under IFRS inventory should be valued at the lower of cost and net realisable value. IFRS specifically recognises the retail inventory method for inventory valuation as an approximation for cost, noting that the cost/retail value ratio should include permanent markdowns. [IAS 2.21/22].

Solution

The retail inventory method is a mechanism that some retailers use to value inventory, basing that valuation off the cost/retail value ratio to the retail value of closing inventory. This mechanism recognises that applying other valuation methodologies may be impractical in a retail environment.

Retail Department A: The methodology for applying the retail inventory method results in an inventory valuation that approximates cost as both the current retail value and the cost/retail value ratio used in the calculation include permanent markdowns.

Retail Department B: The methodology for applying the retail inventory method results in an inventory valuation that may not approximate cost (CU60 vs CU54) depending on the amount of permanent markdowns made, as the cost/retail value ratio used in the calculation excludes markdowns. This calculation methodology could result in inventory being written down below original cost when net realisable value is in excess of original cost, which would not be acceptable under IFRS.

US GAAP comment

The retail inventory method is permitted by US GAAP [ASC 330–'Inventory'] and applied in practice by a number of retailers. In applying the conventional retail inventory method the cost/retail value ratio used to calculate the value of inventory excludes markdowns. The methods utilised by both Retail Department A and B would be acceptable under US GAAP.

46. Accounting for inventories in a business combination



Background

Retailer A acquired Retailer B in a business combination. Retailer B has material levels of inventory in its numerous stores.

Issue

How is Retailer B's inventory measured in the purchase price allocation?

Relevant guidance

IFRS 3R requires that inventory be measured at its fair value on the acquisition date. 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.'* The fair value of merchandise would be based on selling price, less the sum of (a) the costs of disposal, and (b) a reasonable profit allowance for the acquirer's selling effort based on profit for similar merchandise.

Solution

Ordinarily, the amount recognised for inventory acquired in a business combination at fair value would be higher than the amount recognised by the company being acquired before the business combination. This is certainly the case when a CPG company that manufactures products acquires another CPG company.

In the case of Retailer A's acquisition of Retailer B, however, careful consideration would be required to other factors that could lead to a conclusion that the acquired inventory is recorded at historical cost:

- *Merchandise is in the form of fresh food*— Given the short shelf life of this inventory, there are generally no significant future selling efforts. The difference between the historical cost and the ultimate selling price could be considered to be a 'reasonable profit allowance', and therefore historical book value could approximate fair value.
- *Common products*—If Retailer B has similar products and brands to Retailer A it could be asserted that Retailer A buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require [IAS 40.42; IFRS 3R.BC250]. Retailer A would not therefore pay a higher price than the historical book value, and therefore book value approximates fair value. As with the fresh food example above, the difference between the historical cost and the ultimate selling price could be considered to be a 'reasonable profit allowance' for Retailer A's selling efforts.



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Contacts

PwC Retail & Consumer Industry Accounting Group

David Mason

Geneva

david.mason@ch.pwc.com

+41 58 792 9490

Christine Bouvry

Paris

christine.bouvry@fr.pwc.com

+33 1 56 57 80 49

Tony de Bell

Global ACS London

tony.m.debell@uk.pwc.com

+44 20 721 35336

John Ellis

London

john.ellis@uk.pwc.com

+44 20 780 46241

James Geary

New York Metro

james.w.geary@us.pwc.com

+1 973 236 4497

Sebastian Heintges

Düsseldorf

sebastian.heintges@de.pwc.com

+49 211 981 2873

John Ryan

Hong Kong

john.j.ryan@hk.pwc.com

+852 2289 2688

Peter Schlicksup

US ACS

peter.j.schlicksup@us.pwc.com

+1 973 236 5259

Paul Sheward

Chicago

paul.sheward@us.pwc.com

+1 312 298 2232

Julia Tabakova

Moscow

julia.tabakova@ru.pwc.com

+7 495 232 5468

Alison Tait

Melbourne

alison.tait@au.pwc.com

+61 3 38603 213

Editorial Board

David Mason

Tony de Bell

James Geary

Paul Sheward

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