Retail and Consumer

Issues and Solutions for the Retail and Consumer Goods Industries

International Financial Reporting Standards / US GAAP

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Foreword

At the time of the run-up to the EU implementation of International Financial Reporting Standards in 2005, PricewaterhouseCoopers published "IFRS in Action", to help board members in the retail and consumer goods industries understand the implications of the change to IFRS. Three years later, industry reporting practice is becoming clearer, more countries have decided to move to IFRS and others, specifically the US, are considering that option.

We have taken this opportunity to refresh and expand our IFRS framework for financial reporting across a range of issues in the retail and consumer sector. Our global network of retail and consumer engagement partners understands the specific accounting challenges for the industry, as they are often the first to assist preparers 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 industries.

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 retail and consumer contact.

We have also added a US GAAP perspective to assist companies reporting under this framework to understand the impact IFRS could have on their financial statements.

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

Carrie Yu
Global Retail and Consumer Leader

David Mason
Chairman, Retail and Consumer Industry Accounting Group

Introduction

This publication summarises some of the complex accounting areas that are specific to the retail and consumer industry. These areas cover the full value chain from the conception of a product by a consumer goods company to its distribution to the final customer. This value chain is illustrated in the table of contents of this publication. Some aspects of IFRS 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.

The retail and consumer industry

The retail and consumer industry comprises three main participants: the supplier (referred to as "CGC" or consumer goods company), the retailer and the final customer.

- The CGC 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 CGC and the consumer. The retailer's activity typically comprises the purchase of products from the CGCs 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 retail and consumer value chain, from the innovation function of the CGCs 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

The possibility of moving to a single set of global accounting standards has gained momentum in the US with the SEC's recent proposed roadmap to converting to IFRS. The main differences and similarities between US GAAP and IFRS are highlighted in the solutions. They also include references to help companies identify specific accounting issues relevant to US retail and consumer goods businesses.

Key:

Similar to IFRS

Overall approach is similar to IFRS, but detailed application needs to be carefully reassessed as significant differences may arise from specific issues

Specific differences to IFRS may exist

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Innovation, brand, R&D, licensing, marketing and advertising

1 Development costs

Background

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

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

Relevant guidance

IAS 38.57 states that an intangible asset arising from development (or from the development phase of an internal project) is recognised as an asset 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

The development costs should be capitalised if all the criteria in IAS 38 are fulfilled. It is sometimes difficult to determine the point at which the criteria are met.

US GAAP comment

Development costs are expensed as incurred in accordance with FAS 2 par.12, “Accounting for Research and Development Costs”.

2 Advertising costs

Innovation, brand, R&D, licensing, marketing and advertising

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.

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

Relevant guidance

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 38.68-70].

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

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 expensed in the following period when those services are delivered.

US GAAP comment

In most instances, the development and conception of a new advertising campaign is usually considered as “Other than direct-response advertising” under Statement Of Position 93-7, “Reporting on 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 applied consistently to similar transactions.

Consistent with IFRS, the remaining CU 1 million is recognised as a prepayment.

3 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.

When are the costs expensed?

Relevant guidance

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 38.68-70].

IAS 38 states that an expense is recognised when an entity has the right to access the goods or services.

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 or expected to be used – in which case, their cost is a cost of advertising [Statement Of Position 93-7, "Reporting on Advertising Costs"].

4 Coupons

Innovation, brand, R&D, licensing, marketing and advertising

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 have been sold and reduction coupons issued.

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].

Solution (Fair value approach)

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.

$$\left(\frac{20}{21} : \frac{1}{21}\right)$$

5 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 manufacture of Company B's products into its own facilities. The manufacturing facilities of Company B will be closed down.

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.

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 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 FAS 142, "Goodwill and Other Intangibles", 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.

6 Sales to a franchisee

Background

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

The franchiser 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.

(a) How does the franchiser account for the up-front payment?

(b) How is the sale of product A accounted for by the franchiser?

(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 criterion 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 franchiser 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.

(b) Sales to the franchisee are treated in the same way as the sale of goods to other customers. The lower sales price is compensated for by the franchise fee over the contract period.

(c) The franchisee should recognise an intangible asset (distribution rights) and amortise it over the five-year period.

US GAAP comment

In accordance with FAS 45 par. 15, "Accounting for Franchise Fee Revenue", 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 franchiser to recognise the fee relating to the access to the franchise on a straight line basis when the franchiser is unable to estimate the amount of units expected to be sold over the term of the franchise arrangement.

7 Tax implications of brands with indefinite lives

Innovation, brand, R&D, licensing, marketing and advertising

Background

Company A purchases 100% of Company B and identifies a brand with an indefinite life.

Management intends to maintain both the brand and the business acquired and has no plans to either discontinue or sell the brand.

The brand has no tax basis. Management believes that no deferred tax should be recorded, arguing that since the brand has an indefinite life the deferred tax liability will never be realised. Is this appropriate?

Relevant guidance

Temporary differences may arise in a business combination as a result of the difference between the tax bases of identifiable assets acquired and liabilities assumed and their fair value.

IAS 12.66 requires deferred tax to be recognised on all temporary differences that arise as a result of a business combination, with the exception of the initial recognition of goodwill.

The second paragraph of the objective of IAS 12, 'Income taxes', states: 'It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.'

Solution

A deferred tax liability is recognised on indefinite life intangibles acquired in a business combination. The liability remains on the balance sheet and is released to the income statement on sale or impairment of the asset.

8 Up-front fees

Innovation, brand, R&D, licensing, marketing and advertising

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 licence 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 B not meet minimum revenue levels.

How is this up-front fee 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 number of sales to be made in the future or over the duration of the licence agreement.

9 Useful life of brands

Innovation, brand, R&D, licensing, marketing and advertising

Background

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

- 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.

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 the asset is expected to generate net cash inflows for the entities [IAS 38.88].

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;
- 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 a specific guidance under FAS 142, "Goodwill and Other Intangibles" par. 11 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.

Based on the above considerations, the perfume named after the famous star is likely to have a finite life.

10 Franchise arrangements

Innovation, brand, R&D, licensing, marketing and advertising

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. However, it has no right to return any inventory purchased from the retailer.

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 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 that are collected on behalf of the principal and that 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 fee, which should be recognised as revenue by the retailer/franchisor, spread in an appropriate manner over the life of the franchise agreement.

Production, buying, manufacturing

11 Net settlement of purchase contracts

Production, buying, manufacturing

Background

A processor of edible oils uses forward purchase contracts with future physical delivery to protect itself against fluctuations in the price of the edible oils. It sometimes takes delivery of the oil; however, the contract allows net settlement in cash as an alternative to taking physical delivery (the net cash settlement is based on market value changes in the price of the specific type of edible oil since inception of the contract), and the entity sometimes uses this option. When the contract is settled net, the entity uses the proceeds of the settlement to purchase another type/quality of edible oil, or purchase it in another place.

Relevant guidance

IAS 39.9 defines a derivative that needs to be accounted at fair value through profit and loss as a financial instrument with the following characteristics:

- Its value changes in response to changes in an 'underlying' price or index – for example, the price of a certain type of edible oil;
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors (in the case of future purchase of edible oil, the initial net investment is nil);
- It is settled at a future date.

However, when the contract's purpose is to take physical delivery, the contract is generally not considered to be a derivative [IAS 39.5], unless a practice exists of settling other similar contracts on a net basis [IAS 39.5].

How are the forward purchase contracts accounted for?

Solution

The forward contracts should be accounted for at fair value through the profit and loss. Taking physical delivery in connection with a particular contract is not sufficient when:

- the entity has a practice of settling similar contracts net in cash;
- for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery.

The entity may consider applying hedge accounting in accordance with IAS 39 to avoid earnings volatility resulting from carrying these contracts at fair value through profit and loss.

12 Hedge accounting for commodities

Production, buying, manufacturing

Background

A chocolate manufacturer uses commodity futures on the London International Financial Future and Options Exchange (LIFFE) to protect itself against movements in cocoa prices. Futures contracts are derivatives, and the manufacturer intends to apply hedge accounting to protect itself from undesired earnings volatility.

The company designates forecasted purchases of cocoa as the hedged item in a cash flow hedge relationship.

The expected purchases of cocoa to be hedged with futures contracts may be of a different type and may take place in a different market than those for which futures are available.

Can the chocolate manufacturer apply hedge accounting for its hedges of future commodity purchases?

Relevant guidance

If the hedged item is a non-financial asset or liability, it is designated as a hedged item in its entirety for all risks [IAS 39.82].

IAS 39 is restrictive because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks for non-financial items.

Solution

Assuming all documentation criteria are met, the chocolate manufacturer is allowed to apply hedge accounting. However the hedge relationship exists only for the entire price risk of the cocoa to be purchased. All price changes of the specific commodity (the hedged item), including its specific quality and geographical location, are taken into account and compared with changes in value of the cocoa future (the hedging instrument). If the two contracts have different price elements ineffectiveness will occur. Special attention should be given to the impact of transportation costs which will also create hedge ineffectiveness.

Cash flow hedge accounting can be applied as long as the ineffectiveness is not outside the range of 80-125%.

13 Embedded derivatives

Production, buying, manufacturing

Background

A Dutch entity with a euro functional currency has entered into a long-term commitment to buy coffee from a UK-based CGC with a GBP functional currency. The commitment stipulates a fixed purchase price in Swiss francs (CHF).

What are the factors that determine whether or not a foreign exchange (FX) embedded derivative exists in connection with a foreign currency commitment?

What are the implications for the hedging strategy of the company?

Relevant guidance

IFRS defines an embedded derivative as a component of a hybrid (combined) instrument that also includes a non-derivative host contract, with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

Whether an embedded derivative needs to be bifurcated (i.e., accounted for separately) depends on whether the host contract is already measured at fair value, whether the embedded derivative would be a derivative if it was a stand-alone instrument and whether or not the embedded derivative is closely related to the host contract.

The determination of whether the derivative is closely related is illustrated in examples in IAS 39's application guidance.

Solution

A foreign currency denominated contract contains a FX embedded derivative requiring separation unless it meets one of the following criteria (IAS 39.AG33d):

- The contract is denominated in the functional currency of one of the two parties.
- The currency of the transaction is that of routine denomination for the commodity in international business (for example, USD for oil).
- The currency is commonly used in that particular market (for example, USD in Russia).

In this example, CHF is not the functional currency of either party to the contract. Coffee is not routinely denominated in CHF, and CHF is not a currency commonly used in business transactions in the Netherlands. An embedded derivative should be accounted at fair value through profit and loss.

If the company hedges the euro/CHF exposure with FX forward contracts, the embedded derivative would largely offset the results on the FX forwards. The company would therefore avoid the burden of having to apply the complex hedge accounting rules, which would otherwise be required to avoid volatility.

US GAAP comment

The concept of a currency commonly used in that particular market does not exist in US GAAP.
FAS 52 "Foreign Currency Translation" only refers to the concept of functional currency.

14 Biological assets

Production, buying, manufacturing

Background

A company sets up a tea plantation, incurring expenses of CU 2 million. The tea bushes will take 10 years to mature and will then produce leaves for harvesting for 30 years. During the period to maturity the company will incur only maintenance costs. Thereafter the company will incur harvesting costs as well as maintenance costs. It will also receive revenues from the sale of the leaves to tea manufacturers.

How does management account for the tea bushes (being the biological assets)?

Relevant guidance

IAS 41 applies to agricultural activity, which is defined as 'the management by an entity of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets'.

Biological assets are defined as living plants or animals and are measured, both at initial recognition and at each subsequent reporting date, at fair value less estimated point-of-sale costs [IAS 41.12].

Gains or losses arising on remeasuring fair value are recognised in the income statement in the period in which they arise [IAS 41.26].

The term 'point-of-sale costs' defined in IAS 41 is equivalent to the 'costs to sell' as used in other IFRSs. This encompasses commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. However, it specifically excludes transport and other costs necessary to get assets to a market [IAS 41.14]. This is because transport costs would be taken into account in determining the fair value above.

Solution

Where available, the fair value of biological assets should be based on market prices. If there is no market for recently planted tea bushes and there is no market-based data on the basis of which fair value could be estimated, the fair value is determined on the basis of the present value of expected future cash flows. When growth becomes a more significant contributor, fair value is determined using estimated yield, revenue and costs/overheads discounted at the market/sector cost of capital plus an asset-related risk premium. The difference between fair value and the set-up costs of CU 2 million is either a gain or loss in operating profit.

At each subsequent reporting date, management uses revised projections (based on crop density/yields and market price predictions) to re-measure the biological assets, recognising the fair value gains or losses within operating profit.

Maintenance costs are expensed as incurred. The revenue from tea sales is recognised at the time of sale to external buyers.

US GAAP comment

Tea bushes are accounted for at historical cost of purchased seeds plus value added for transportation, labour, water, and other costs to grow the agriculture. No gain is recognised until a sale occurs.

Selling to retailers

15 Trade loading

Selling to retailers

Background

An electronics CGC 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 20X8. The retailer has an unrestricted right of return during the first six months of 20X9, 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 20X8. All remaining terms and conditions remain the same.

To what extent can the CGC recognise revenue?

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 CGC 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 CGC does not recognise revenue for this transaction in 20X8.

(b) The arrangement provides the CGC with the sale of goods at a lower margin. The CGC 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.

16 Buy one get one free

Selling to retailers

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.

(a) How is a 'buy one get one free' transaction accounted for?

(b) How is this transaction presented?

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 [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.

17 Close-out fees

Selling to retailers

Background

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

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

There is no right to return the products to the CGC.

How should a CGC 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 CGC 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 is recognised when the goods are delivered. The manufacturer should also consider the impact of the discount on the net realisable value of its inventory.

18 Pallet allowances

Background

A retailer buys a pallet of goods from one of its major CGCs. 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 CGC gives a discount to the retailer justified by expectations of increased sales volumes and reduced packaging and handling costs.

How does a CGC 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 CGC recognises revenue from the sale of the pallet of goods net of the amount of the discount given to the retailer [IAS 18.10].

19 Integrated value partners agreement

Selling to retailers

Background

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

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

How does CGC 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 CGC recognises revenue from the sale of the full truckload of goods reduced by the amount of the discount given to the retailer.

20 Co-advertising services

Selling to retailers

Background

Entity B is a beverage CGC. It has agreed to enter into a joint advertising arrangement with one of its retailers, under which advertisements are to be published in a local newspaper.

Entity B has had arrangements in the past directly with the local newspaper and, absent the arrangement with the retailer, would advertise locally as in the past.

The retailer will contract directly with the local newspaper and pay for the full cost of the campaign. A separate contractual arrangement between the retailer and the CGC commits the CGC to reimburse 50% of the advertising costs.

How do the CGC and retailer present this transaction?

Relevant guidance

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

Consideration is 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

The retailer is acting as a purchasing agent for the CGC. The advertising cost is separable from the supply relationship and the advertising payment to the retailer reflects the fair value of the advertising services received:

- The retailer presents the payment made to the advertiser on behalf of the CGC as a receivable.
- The beverage CGC presents the payment made as a marketing expense.

21 Retail markdown compensation

Background

Markdown compensation is an arrangement between a CGC and a retailer under which the CGC pays compensation to the retailer for markdown losses. The objective of the arrangement is for the CGC 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 the 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.

How and when do the CGCs account for the markdown compensation that they grant 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 CGC 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.

22 Scan deals

Background

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

A CGC 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.

It is unlikely that CGCs would have an established practice of scan deals.

The CGC's normal selling price to the retailer is CU 80; the selling price from the retailer to the customers is CU 100. The CGC 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 CGC at the end of the promotional period and reimburses any unearned discount.

How does the CGC 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

The CGC 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 would also be adjusted against revenue.

23 Provision for returns from resellers/wholesalers

Selling to retailers

Background

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

Although there is no contractual obligation, how does entity A provide 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.

24 Slotting fees and listing fees

Background

Two similar arrangements between CGCs and retailers are as follows:

- Slotting fees: retailers give CGCs 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: CGCs pay fees to the retailer in order to be included in the retailer's list of authorised CGCs.

How do the retailers and CGCs each present these transactions?

Relevant guidance

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 CGCs 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) for the retailers.

The CGC recognises the related expenses as a deduction of revenue.

25 Excise tax – Net presentation

Selling to retailers

Background

A CGC 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.

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 that is generated 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 that 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 excise tax linked to the sales price of the product?
- Point of payment: Are excise taxes paid close to production or close to the final sale of inventory?

Solution

The entity presents revenue net of excise taxes in its income statement. The excise tax is similar to a sales tax, and the entity is acting as an agent to collect it for the government. The revenue is therefore shown net of excise taxes as the amounts are collected on behalf of the government.

US GAAP comment

EITF 06-3, “How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)” provides guidance on the income statement classification of taxes assessed by a governmental authority.

Taxes within the scope of EITF 06-3 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 EITF 06-3.

The EITF determined that, unlike IFRS, reporting taxes (within scope) on either a gross basis (included in revenues and costs) or a net basis (excluded from revenues) is an accounting policy decision that is disclosed pursuant to APB Opinion No. 22 “Disclosure of Accounting Policies”. 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.

26 Excise tax – Gross presentation

Selling to retailers

Background

An entity manufactures cigarettes. Excise tax legislation in country Y requires the entity to pay excise tax calculated as a fixed amount per pack of cigarettes produced. The tax is payable when the cigarettes are produced. The excise tax is not refundable if the packaged inventory is damaged or not sold by the manufacturer.

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 that is generated 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 that flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue [IAS 18.8].

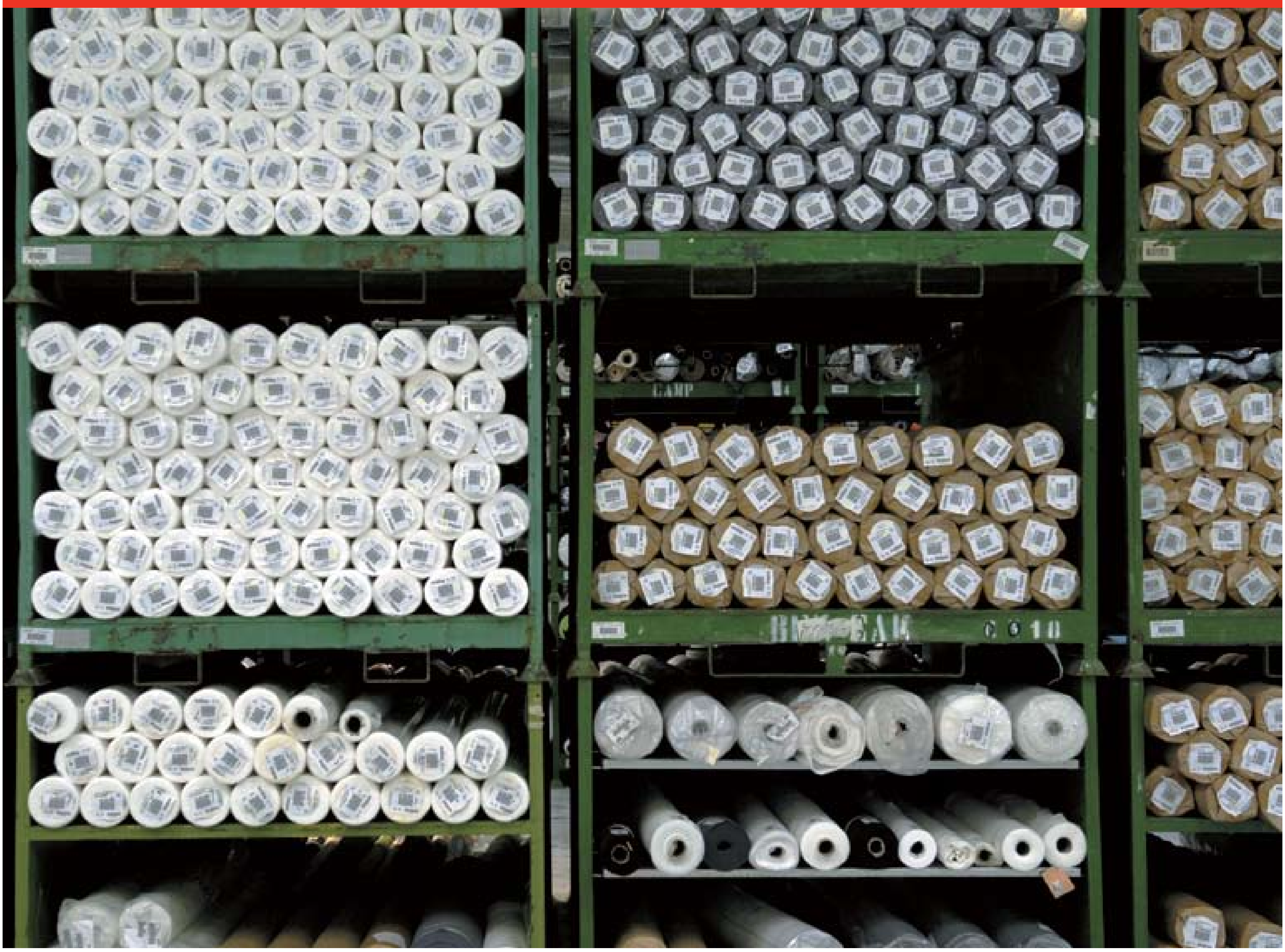
Factors that can be considered:

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

Solution

The entity presents excise taxes gross as part of cost of sales. The excise tax is similar to a production tax, as the calculation is based on physical quantity produced, is not refundable and the timing of payment is at the production of the cigarettes.

Storage



27 Shrinkage

Storage

Background

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

How does management account for shrinkage?

Relevant guidance

Inventories are measured at the lower of cost and net realisable value [IAS 2R.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.

28 Warehouse costs

Storage

Background

A retailer purchases finished goods and stores them in a warehouse before delivery to its retail stores.

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

Are these costs included in inventory or are they expensed as incurred?

How does a retailer account for intermediate warehouse costs?

Relevant guidance

The cost of inventories includes the cost of all materials that enter directly into production and the costs 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 2R.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.
- Selling costs [IAS 2. 6].

Solution

Intermediate storage costs represent an unavoidable part of the supply chain in getting inventories to their present location and condition and are therefore included in the cost of inventory.

'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.

US GAAP comment

There is no authoritative guidance on distribution and warehousing costs for finished goods. Individual facts and circumstances determine if these costs are included in the cost of inventory.

Property and leases

29 Rent-free periods

Background

A retailer enters a lease agreement for a period of five years.

The agreement specifies that the retailer will not have to make any payments during the first year of the lease term. The retailer will have to make monthly payments of CU 100,000 from the second year onward.

Management has appropriately classified the agreement as an operating lease.

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

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 17R.33].

All incentives for the agreement of a new or renewed operating lease shall be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or form or the timing of payments [SIC 15.3].

The lessor shall recognise the aggregate cost of incentives as a reduction of rental income over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished [SIC 15.4].

Solution

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

The retailer recognises the rental expenses in the income statement on a straight-line basis over the five years of the agreement. The retailer's annual rental expense is therefore CU 80,000 (CU 100,000 x 48/60) during years one to five.

30 Rent-free periods – Renewal options

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. 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.

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 17R.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 reasonably certain to be exercised at the inception of the lease [IAS 17R.3].

Solution

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.

31 Treatment of lease incentives

Property and leases

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.

How does 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 17R.4].

Lessees in finance leases include initial direct costs as part of the cost of the asset. The initial direct costs must be directly attributable to negotiating and securing the lease arrangement [IAS 17R.24].

Lease payments under an operating lease are 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 measures 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 calculation of initial direct costs and amortised over the lease term. The accretion of interest on the loan is interest income.

US GAAP comment

The IFRS approach is acceptable under US GAAP; however, the most 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.

32 Key money

Property and leases

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 key money to the incumbent tenants to obtain the leases. Management's explanation of the magnitude of the key money differs according to location.

- Paris store: The landlords' powers in France are restricted. They 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 charge.

  The key money represents the difference between current rents and fair market rents, plus an additional premium paid to obtain the site ahead of a competitor. The retailer expects to be able to recover at least the original investment from the tenant who takes over the lease when they move 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.

How does management of a lessee account for the key money 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. These payments (key money) are different from payments made to the landlord and are not covered by IAS 17, 'Leases'. 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.

Solution

Paris – Capitalise as a long-lived asset and amortise over the estimated useful life of the rental premises to the company. This cannot exceed the estimated remaining life of the premises.

Zurich – Capitalise as a long-lived asset and amortise over the remaining term of the lease (five years).

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

33 Contingent rental payments

Background

A real estate entity builds a new shopping centre.

Entity A, a retailer, enters a lease with the real estate entity.

The lease agreement requires A to pay rent equal to 3% of its monthly sales in the shopping centre subject to a minimum payment of CU 200 per month.

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

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 17R.4].

Minimum lease payments are the payments over the lease term that the lessee makes, excluding contingent rent, cost for services and taxes to be paid by and reimbursed to the lessor [IAS 17R.4].

Solution

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

The incremental rent triggered when monthly sales exceed CU 6667 (6667 = 200/3%) is contingent rent and should be recognised as an expense when incurred.

34 Contingent rents in interim reporting

Property and leases

Background

Entity A, a retailer, operates from a leased store. It pays rent for the store as follows:

(a) 3% of each month's sales; 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.

Does management account for the contingent rent payments at the year-end and in interim financial statements?

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 17R.33].

If a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, an obligation can arise in interim periods before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity has no realistic alternative but to make the future lease payment [IAS 34.App B.7].

Solution

Contingent rental payments are accounted for in the interim financial statements on the basis of management's best estimate of whether it will pay 3% or 4% of sales as rental.

Entity 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.

When preparing the interim financial statements, rent for the entire period is estimated based upon the expected revenue profile.

US GAAP comment

EITF 98-9 would apply. The principal is similar but the threshold for recognition and derecognition is not identical. Also, US GAAP does not prescribe how the liability for progress toward the target should be recognised.

35 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 with a commitment not to change it. It has also started an active search for a buyer of the store's assets.

Management has not recognised any impairment loss in the financial statements in previous years.

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

Relevant guidance

If there is an indication of impairment, the entity estimates the recoverable amount of the asset [IAS 36R.9].

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 36R.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, and its carrying value will reflect the lower of carrying value or recoverable value in accordance with IAS 36.

US GAAP comment

There is a different definition in US GAAP of the 'operating unit' 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 is a triggering event. The store is therefore tested for impairment under FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". Management's probable plans of disposal should be considered in estimating future cash flows.

36 Allocation of rebates to CGUs

Property and leases

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.

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 36R.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.

37 Pre-opening costs

Background

A chain of supermarkets has acquired 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 remodelling costs, salaries of staff who will be preparing the store before its opening, and related utilities costs.

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 for it to be capable of operating in the manner intended by management [IAS 16R.16(b)]. These include external costs, such as delivery and installation costs, architects' fees and import duties [IAS 16.16-17(R05)].

Internal costs to be capitalised include directly attributable overhead costs where applicable [IAS 16.22(R05), IAS 2.12(R05)]. Overhead costs relating to unproductive or inefficient use of resources are expensed as incurred [IAS 16.22 (R05)].

General administrative costs not directly attributable to the acquisition, construction or commissioning of the asset are also expensed as incurred [IAS 16.19, 20 (R05)].

Solution

The costs of construction and remodelling the supermarket are capitalised, because they are required to bring the store to the condition necessary for it to be capable of operating 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 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 be capable of operating in the manner intended by management. They are expensed as incurred.

US GAAP comment

SoP 98-5, "Reporting on the Costs of Start-Up Activities" requires expensing all "start-up costs" unless contradicted by other authoritative literature.

The reconstruction of the store might fall within the scope of EITF 97-10 "The Effect of Lessee Involvement in Asset Construction" and, if so, the lessee might be considered the owner of the store during the construction period. If so, all of the costs relating to the store construction, including the shell, would be capitalised. In this case ground rent, actual or imputed, would be charged to expense during the construction period; it would not be capitalised (FSP FAS 13-1).

If the lessee is not deemed to be the owner of the construction project during the construction period, the accounting would generally mirror the accounting set forth in the IFRS solution. However, recognition of rent expense for the entire property would likely commence at the beginning of the renovation.

38 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.

How does the department store account for this arrangement?

Relevant guidance

In an agency relationship, the gross inflows of economic benefits include amounts that are collected on behalf of the principal and that do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. 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.
- The entity has discretion in selecting CGCs.

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.

39 Make-good provisions

Property and leases

Background

Retailers often enter into lease agreements with clauses that require the retailer to restore or repair the leased property to its original condition at the end of the lease term.

Entity X, a retail store chain, leases several stores for 10 years with options to extend the leases. The leases require that Entity X restore the stores to the original condition at the end of the lease terms, even if the lease is terminated early.

The restoration to the original condition means that the entity will have to 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.

When does management recognise a provision for expenditure to be made to restore leased property to its original condition at the end of the lease term?

Relevant guidance

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

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period [IAS 16.16].

A provision is 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; and

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

No provision is recognised if these conditions are not met [IAS 37.14].

Solution

There are two types of make-good obligations:

- An asset that is added to the leased premises that must be removed at the end of the lease. 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. 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 premise 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 FAS 13, "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 FAS 143. Under FAS 143, "Accounting for Asset Retirement Obligation" and the related interpretation FIN 47, "Accounting for Conditional Asset Retirement Obligation", 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.

40 CGU's – Clustering for a chain retailer and flagship stores

Property and leases

Background

A retail store chain A owns 300 stores nationally. The stores are generally located in different neighbourhoods; 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.

Store Z is a flagship store located in a prime site location in New York.

Can stores X and Y be considered to be a single CGU?

Can store Z be considered a CGU together with the corporate headquarters as it raises brand awareness in the market?

Relevant guidance

The recoverable amount of an asset is determined on an individual asset basis unless the asset does not generate cash inflows that are largely independent of other assets or groups of assets. Where it does not generate such independent cash flows, the recoverable amount is determined for the CGU to which that asset belongs.

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 Appendix 1 considers CGUs for a chain retailer with no stores in the same neighbourhood and concludes that the CGU is at a store level.

An IFRIC rejection in March 2007 states that 'independent cash flow' of IAS 36 does not mean net cash flow. Independent outflows are not therefore taken into consideration in the analysis.

Solution

Stores X and Y are separate CGUs as each store generates cash inflows that are independent of the other store. The fact that they incur costs centrally is not relevant.

Store Z is a CGU separate from the other stores and the headquarters as it generates independent cash inflows.

US GAAP comment

Clustering for a chain is possible under FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". For example, if it is determined that customers would frequent either store X or Y then those stores would 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.

In the case of the flagship stores which benefits of all the other stores (for example advertising the store brand, marketing, etc.), it may be appropriate to consider the cost of operating the flagship stores as part of corporate costs and therefore the flagship store may not necessarily be the lowest level of identifiable cash flow.

41 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.

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, and if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes, the property is investment property [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.

42 Acquisition of retail space

Property and leases

Background

A retailer purchases entities X, Y and Z from a company that owns a shopping mall. Each entity owns a retail space in the mall. Entities X, Y and Z have been carved out from the company that owns the shopping mall and transferred into a new company (created solely for the purpose of the acquisition).

X, Y and Z's only assets are the retail spaces in the mall. All operational activity is performed by the owner of the mall. The related expenses are charged to X, Y and Z. The entities have no employees.

How does the retailer account for the purchase of X, Y and Z?

Relevant guidance

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. [IFRS 3(R). Definitions].

Solution

Entities X, Y and Z do not meet the definition of a business in IFRS 3, 'Business combinations', as they do not have any processes (for example, real estate management), which are applied to inputs (retail space) or generate outputs (rent revenue). The acquisition is treated as a purchase of assets in accordance with IFRS 3.4. The retailer allocates the purchase price between the properties acquired based on their relative fair value and no goodwill will arise on the transaction.

Sales and marketing

43 Right of return in exchange for cash or vouchers

Sales and marketing

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.

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

(a) The retailer's management 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.

(b) The retailer recognises revenue on the sale of the goods, with a 5% adjustment to revenue through the recording of a provision to reflect the risk of lost margin on returns. The recognition of revenue and the provision for returns is made when the sale is made.

(c) The retailer would recognise a 10% adjustment to revenue for the risk of return when the sales are made. The amount of inventory expected to be returned would be recognised as a current asset, as the inventory is expected to be returned undamaged and resaleable for its full price.

US GAAP comment

Solutions (a) and (c) as stated above would be acceptable.

44 Discount coupons

Background

A clothing retailer has launched a promotional campaign. It publishes a coupon 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.

How does a retailer account for the distribution of 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

The retailer does not recognise a liability for the distribution of coupons in its financial statements. 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.

45 Discount coupons (combined purchase)

Sales and marketing

Background

A retailer that operates a chain of pizza restaurants has launched a marketing campaign to attract new customers. The retailer distributes a series of coupons granting the customers a free dessert when they have a main course at any restaurant in the chain.

The average sales price of a main course is CU 10, with a cost of CU 6. The average sales price of a dessert is CU 5, with a cost of CU 2.

Does the retailer recognise a provision for the distribution of coupons for free products as part of a combined purchase?

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

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 dessert is a cost of sales and not a marketing cost, the same as 'buy one, get one free' offers.

46 Revenue from the sale of gift vouchers

Sales and marketing

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.

Does the retailer:

(a) recognise revenue on the sale of gift vouchers?

(b) recognise revenue for vouchers that remain unredeemed for an extended period?

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

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.

47 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 1.25.

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' (applicable for annual periods beginning on or after 1 July 2008). 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) = number of loyalty points x redemption rate x fair value per point
= 100 pts x 80% x 1.25
= 100

(b) Deferred revenue (relative fair value) = (total consideration x fair value of award points) / (total consideration + fair value of award points) = (1,000 x 100) / (1,000 + 100)
= 91

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 historic experience.

US GAAP comment

It is acceptable to account for loyalty programmes as multiple-element arrangements using an analogy to EITF 00-21, "Revenue Arrangements with Multiple Deliverables". In multiple element arrangements breakage can not 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.

Background

A retailer sells electrical goods. The goods 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.

How is this arrangement accounted for?

Relevant guidance

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].

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].

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.

The costs incurred to fulfil 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

FASB Technical Bulletin 90-1, "Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts", addresses the accounting for separately-priced extended warranty and product maintenance contracts. It is different from IFRS in that it requires the deferral of revenue generated by the separately-priced warranties and product maintenance contracts based on the contractual terms of the arrangement. The revenue related to separately-priced warranty and maintenance are determined by reference to the selling price for maintenance contracts. Deferred amounts are recognised in income on a straight-line basis over the contract period except where sufficient historical information indicates that costs of performing such services are incurred on other than a straight-line basis.

49 Interest-free financing

Sales and marketing

Background

A retailer offers two interest-free financing arrangements to its customers:

(a) The customer signs a finance agreement with a third-party financing company, which then pays the retailer the full sales price less finance charges; and

(b) The retailer finances the interest-free offer itself, allowing the customer to pay the full price in two years.

How is interest-free financing be accounted for in these two scenarios?

How much revenue does the retailer recognise and when?

Relevant guidance

Where consideration is deferred, the substance of the arrangement is that there is both a sale and a financing transaction. Where this is the case, management discounts the consideration to present value in order to arrive at fair value [IAS 18.11].

Solution

(a) The retailer sells goods to the customer, and the customer simultaneously enters into a finance arrangement with a finance company. The finance company settles the customer's account with the retailer. The retailer recognises as revenue the net amount to be received from the finance company as revenue when the goods are delivered, not the full sales price of the goods.

(b) The retailer recognises the present value of the cash flows receivable as revenue when the goods are delivered. The present value can be calculated by using an appropriate discount rate, such as the interest rate at which the customer could borrow from a third party. The receivable is updated at each balance sheet date to reflect the passage of time; the resulting increase is interest income.

50 Credit card fees

Sales and marketing

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.

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

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 that are collected on behalf of the principal and that do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. 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 management should account for a transaction as a principal include:

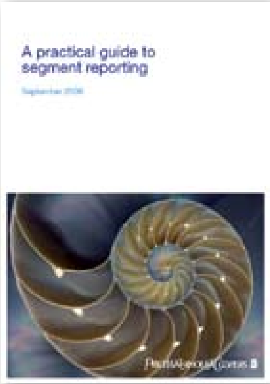
- The customer expects that the entity is acting as the primary obligor in the arrangement.
- The entity is able to set the selling price with the customer.
- The entity has inventory risk.
- The entity performs part of the services provided or modifies the goods supplied.
- The entity has or assumes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

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.

Further reading on retail and consumer sector and IFRS topics, such as the reports below, can be accessed at www.pwc.com/r&c.



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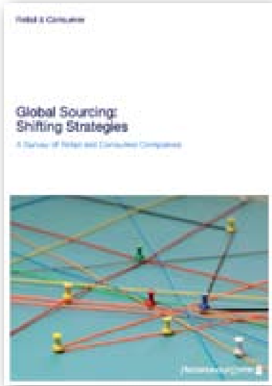

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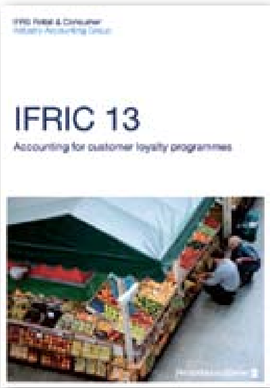
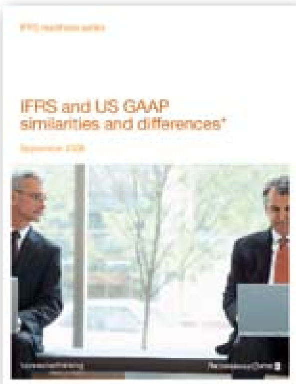
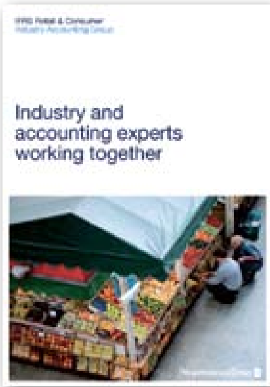


IFRIC 13: Accounting for customer loyalty programmes



IFRS and US GAAP: Similarities and differences



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Contacts

PwC Retail & Consumer Industry Accounting Group

David Mason
Geneva
david.mason@ch.pwc.com
+41 58 792 9490

John Ellis
London
john.ellis@uk.pwc.com
+44 20 780 46241

John Ryan
Hong Kong
john.j.ryan@hk.pwc.com
+852 2289 2688

Ranjan Sriskandan
London
ranjan.sriskandan@uk.pwc.com
+44 20 780 45269

Julia Tabakova
Moscow
julia.tabakova@ru.pwc.com
+7 495 232 5468

James Geary
Florham Park
james.w.geary@us.pwc.com
+1 973 236 4497

Daniel Rosenberg
Melbourne
daniel.rosenberg@au.pwc.com
+61 3 8603 3886

Tony de Bell
Global ACS London
tony.m.debell@uk.pwc.com
+44 20 721 35336

Christine Bouvry
Paris
christine.bouvry@fr.pwc.com
+33 1 56 57 80 49

Sebastian Heintges
Düsseldorf
sebastian.heintges@de.pwc.com
+49 211 981 2873

Editorial Board:

David Mason

Tony de Bell

James Geary

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