

# IFRS news

Emerging issues and practical guidance\*

Supplement – IFRS by industry

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## Big changes ahead for retail and consumer entities



The IASB and FASB have a full agenda, reassessing several different accounting areas under both frameworks. Two projects that will have significant impact on retail and consumer entities are leasing and revenue recognition. Dave Mason, PwC audit partner in Switzerland, and Mark Lohmann, partner in PwC's Accounting Consulting Services Central Team, provide an overview of the status of these projects and the potential impacts on the retail and consumer sector.

### Leasing

The IASB and FASB published a discussion paper on accounting for leases (DP) earlier this year. Much of the criticism of the current standard relates to the fact that the core assets of a business (for example, aircraft/airlines) are not on the company's balance sheet. The assessment of contracts on the borderline between operating and finance leases involves significant time and effort but is often ignored by users. Few retailers are heavily involved in issues relating to lease classification, as their property leases are generally short term compared to the underlying assets. However, the retail industry is likely to be significantly affected by the proposals.

#### Summary of key points in the leasing DP

Accounting for leases has remained largely unchanged since IAS 17, 'Leases', was issued in 1982. Critics argue that the 'all-or-nothing' approach in the distinction between finance and operating leases results in different accounting treatments for similar arrangements. Many important cash-out obligations are also not treated as liabilities.

The DP proposes a 'right of use' approach. This approach requires lessees to recognise an asset for its right to use the leased asset for the lease term, and a corresponding liability for the committed cash outflows. Current operating lease accounting would be eliminated.

The 'right' is measured at the present value of lease payments, discounted at the lessee's incremental borrowing rate. The DP proposes that the 'most likely lease term' should be considered. This would require preparers to make regular assessments as to whether they will take up renewal options. This requirement is crucial for retailers who, in many markets, renew short-term property leases on multiple occasions.

Another area of specific interest is contingent rentals, which are often used for retail outlets. The rent is set as a percentage of store revenues with or without an underlying base rent. The proposal is for contingent rents to be included in measuring the right-of-use asset, using an expected outcome technique. The Boards are split on the treatment of the changes in estimates of contingent rent, and the DP seeks comments on this. The IASB believes changes in estimates of the amount payable should be reflected as an adjustment to the right-of-use asset; the FASB believes such changes should be reflected in income.

Residual value guarantees would also be considered in determining the value of the right-of-use asset, but these are less common in the retail sector.

The IASB and FASB also have different views on presentation. They agree that right-of-use assets should be presented separately from owned assets. The FASB proposes that the liability should be presented separately from other financial liabilities, but the IASB does not believe separate presentation is necessary.

### Implications

The proposed model would significantly change financial statements and financial metrics for many retailers. Preparers should be especially cautious when finalising debt covenants and agreeing compensation targets. Balance sheets will be grossed up, and the unwinding of the discount on the liability will result in higher interest expense in early years compared to the current straight-line operating lease model. However, EBITDA will probably increase, as rental costs will be replaced by right-of-use amortisation and interest expense.

### Quantitative analysis

An analysis of the 2008 financial statements of listed companies shows the dramatic effect the new proposals will have on retail entities. The analysis uses the minimum lease payment disclosures as a proxy for the impact of the proposal. The actual impact will be greater if the proposals on lease renewal options and contingent rents go forward as planned.

The table below shows the impact on debt, leverage and EBITDA across a selection of industries and sub-sectors. It shows median rather than average values in order to reduce the impact on the statistics of outlying companies with low debt and EBITDA figures.

Total cash flows will remain the same – despite the big accounting changes above – unless retailers start to acquire rather than rent properties. However, operating cash inflows will increase, with an offsetting increase in financing cash outflows from the interest charges and investing cash outflows from the acquisition of rights.

### Potential impact of leasing standard on debt, leverage and EBITDA

	Increase in interest-bearing debt	Increase in leverage (percentage points)	Increase in EBITDA
Retail and trade	64%	42%	34%
Other services	16%	17%	13%
Professional services	28%	12%	20%
Transportation and warehousing	14%	9%	14%
Telecom	9%	8%	7%
Wholesale trade	13%	8%	11%
Accommodation	12%	6%	10%
Manufacturing	9%	5%	7%
Construction	3%	4%	6%
Entertainment	5%	4%	5%
Financial services	3%	2%	5%
Oil, gas and mining	3%	1%	2%
Utilities	0%	0%	3%
<b>All companies</b>	<b>8%</b>	<b>4%</b>	<b>7%</b>

### Next steps

The financial statement impacts described above are already significant for the retail industry. It is difficult to estimate the impact on the figures above of including anticipated renewals and contingent rents. However, even if one renewal is assumed, the basic adjusting entries (creation of an asset and an off-setting liability) more than double the asset and liabilities for many entities. If an entity has contingent rents on premium sites that it has no intention of vacating, it may be forced to estimate revenues for that outlet into perpetuity. The estimates of these changes will be a highly significant area of judgement; if any changes in this estimate are recorded in the income statement (as proposed by the FASB), this would result in significant uncertainty and volatility in the results of retailers.

If a new leasing standard becomes applicable from 1 January 2012 with retrospective application, the challenges and questions that retail companies need to address include:

- Can management accurately predict the impact the changes will have on key KPI ratios communicated to investors?
- Does management change the operating model, considering more use of franchise arrangements or reconsidering the 'lease or buy' decisions?
- Does management have the systems and controls necessary to capture, analyse and accumulate the necessary data from a portfolio of outlets that may run into the thousands?
- Does management need to revisit and subsequently renegotiate covenants included in loan arrangements – or even the underlying lease contracts, as lessor accounting is also likely to change?

The impacts of this project are significant – probably one of the most significant accounting changes, at least for retailers. There is much to be done in a short period of time.

## Revenue recognition

Increasing complexity in accounting standards has left many accountants gasping for breath and using experts to help with accounting for pensions, share-based payments, derivatives and goodwill impairment calculations, among other areas. However, every CFO knows what the revenue number is and when to recognise it. All can explain their company's revenue recognition policy and criteria. Thanks to the IASB and the FASB, those policies may be about to change. A long-running project on revenue recognition is moving towards an exposure draft in the second quarter of 2010. It may or may not produce significant changes for companies in the retail and consumer sector; but management will need to think hard before concluding on the impacts.

### Key points in the revenue DP

The Boards produced a joint discussion paper on revenue recognition, 'Preliminary views on revenue recognition in contracts with customers' (DP), in December 2008. The DP comment period ended in June last year. Respondents were generally supportive of the proposals, but there were some concerns about whether one model provides users with decision-useful information in all revenue recognition situations across all industries.

The DP proposes a revenue recognition model based on a single, contract-based, asset and liability model. Entities would recognise revenue upon the satisfaction of performance obligations. This occurs when control of an asset (whether a good or service) transfers to the customer. This is a balance sheet approach to revenue recognition – revenue is an output of changes in assets and liabilities.

*What does this mean in plain English? Apply it to that most simple of retailers – the hot dog vendor on the corner. A customer asks for a hot dog with mustard. The vendor agrees to make the hot dog (grunts and nods) thereby establishing an implicit contract that establishes a performance obligation to provide a hot dog and a right to be paid for it. The vendor puts the hot dog on to cook and asks for the customer's money, in this case \$3. The hot dog vendor has now collected on its right to be paid (the asset) by taking the customer's money. The vendor then delivers the hot dog to the customer and relieves his performance obligation (the liability), as he has delivered control of the asset (the hot dog) to the customer. We will return to this example to illustrate other aspects of the proposed model.*

The Boards have continued to work on the revenue model since the DP was published. They have taken a second look at some

## Resources

- PwC issued a summary of the proposals, 'Future of revenue recognition – A preliminary peek', in February last year.
- A summary of the 220 responses, including PwC observations of each major area, is available in PwC's, 'IASB/FASB revenue recognition project – progress towards completion', issued in September last year.
- PwC's summary of the revenue recognition project is due out in March 2010: 'A summary of the FASB/IASB Revenue Recognition Project – Change is closer than you think'

of the proposals in the DP, including accounting for warranties and rights of return. Measurement of the customer consideration (*that's the \$3 for the hot dog*) has also been on the agenda.

The IASB/FASB staff prepared a summary of the current status of the model last month, reflecting all the preliminary decisions made to date. This summary provides significant insight into the model that the Board will propose in the exposure draft.

### Balance sheet revenue recognition model

The expected model follows the balance sheet approach in favour at the Boards. Revenue arises when an entity satisfies an enforceable contractual obligation (which may be explicit or implicit) to transfer an asset to a customer, referred to as a performance obligation. The contract also conveys to the entity a right to receive payment, referred to as the transaction price.

- The performance obligation is satisfied when control of the asset (a good or service) is transferred to the customer.
- The combination of rights and obligations will result in a net contract asset (remaining rights exceed remaining obligations) or liability (remaining obligations exceed remaining rights). This is the basis for the Boards' balance sheet approach to revenue recognition. It proposes that revenue represents either an increase in a net contract asset or a reduction in a net contract liability resulting from the satisfaction of a performance obligation. *Back to our hot dog vendor. If the preparation was a complex operation that overlapped the end of an accounting period, the vendor would have received the consideration and recognised a performance obligation, resulting in no recognition of revenue in advance of delivery of the hot dog. The hot dog is delivered and the obligation is relieved, thus revenue is recognised because of the reduction in the contract liability.*
- The transaction price in a contract with a customer is allocated to each performance obligation in the contract based on relative actual or estimated stand-alone selling prices. *Imagine our hot dog vendor was offering a package deal of a soft drink, chips and hot dog for \$5. If the elements of the package deal were delivered at different points, the \$5*

would be allocated based on relative stand-alone value of the different pieces. Again, not tricky for the hot dog vendor, as it's all delivered at lunch time and each element has a stand-alone price. Significant complexity could arise if the elements weren't separately available or were delivered at different times.

- The transaction price is the probability-weighted estimate of customer consideration, adjusted for the time value of money, if material, and expected credit losses. It includes contingent consideration unless that amount cannot be reliably estimated. *Our hot dog vendor has taken on a big contract to supply hot dogs for all the executives in a nearby office building. He decides to bill annually, and the price will vary based the volume of sales from other customers. His revenue should be adjusted to discounted present value – so he earns less in January, as he's not going to collect for a year. Our vendor has to make an upfront estimate of potential credit losses – will the firm be there when it's time to settle up? If he can, he may also need to estimate the impact of the volume adjustment to his pricing.*

#### Analysis of certain key areas of interest for retail and consumer entities

##### Warranties

The expected model may require a significant change in the accounting for standard warranties. The warranty obligation will be treated as a failed sale, for which revenue will be deferred, rather than as a cost accrual to provide a replacement.

The expected model is a modification of the proposal in the DP, which proposed treating all warranties as a performance obligation. The Boards have tentatively decided that if the objective of a warranty is to provide a customer with cover for latent defects (defects in existence at sale), that warranty does not give rise to a separate performance obligation. The entity has not satisfied its original performance obligation to provide the asset, and revenue is not recognised for assets (or portions of assets) that must be replaced. Warranties that cover faults that occur after the product is sold (that is, a fault not related to the original product) are similar to insurance and are a separate performance obligation, for which a portion of the transaction price is deferred and recognised as revenue when the service is delivered.

This is a significant change from current requirements for warranties to cover latent defects, which are currently accounted for as provisions. All of the customer consideration is recognised, and the expected cost of the warranty is accrued when the product is sold. The proposals will increase the amount of the liability from the cost to repair to the value of the goods to be replaced or the value of the repair service and will present the impact as a reduction of revenue. *Our hot dog vendor will need to defer a portion of his revenue for those customers who might return and demand a refund or a replacement.*

The impacts of the Boards' proposals are not as significant for many separately priced warranties that in substance provide insurance cover, as revenue is already deferred for these arrangements.

##### Right of return

Accounting for returns will be largely unchanged under the expected model, although it will propose that the balance sheet is grossed up to include the refund obligation and the asset for the right to the returned goods.

The Boards have concluded that:

- An entity should not recognise revenue for the goods that are expected to be returned; it should recognise a refund liability for the expected (probability weighted) amount of refunds to customers.
- An entity should subsequently update the refund liability for changes in expectations about the amount of refunds; it should make a corresponding adjustment to the amount allocated to the performance obligations.
- An entity should recognise an asset (and corresponding adjustment to cost of sales) for its right to recover goods from customers on settling the refund liability, initially measured at the original cost of the goods (that is, the former carrying amount in inventory).
- The promised return service should not be accounted for as a separate performance obligation in addition to the refund obligation.

##### Customer consideration – incentive payments

The expected model is not expected to have a significant impact on current accounting for incentives under IFRS.

The amount a customer pays may vary because of discounts, rebates, refunds, incentives, performance bonuses/penalties, contingencies and other adjustments. A retailer or a consumer goods company may give a customer cash, credit or other items that can be applied against amounts owed to the seller. These incentives could range from a simple loyalty scheme – buy nine hot dogs and get the tenth free – to complex and sophisticated arrangements between consumer goods companies and major retailers. A consumer products company may sell to large retailers and offer volume discounts, marketing allowances or extended payment terms. The proposals suggest that management should use judgement to determine whether those amounts are:

- (a) a reduction of the transaction price and revenue (a discount on the entity's goods or services);
- (b) a payment for distinct goods or services that the entity receives from the customer (that is, the customer is also acting as a supplier to the entity); or
- (c) a combination of (a) and (b).

For the third scenario, the entity reduces the transaction price by the amount of consideration paid to the customer in excess of the fair value of the goods or services received from the customer. *For example, if our hot dog vendor issued a credit to its customer in exchange for advertising services, he would need to determine what the fair value of the advertising was. If the fair value was less than the credit issued, that excess credit would reduce revenue from that customer*

#### Customer consideration – impact of credit risk

The current proposals on the impact of credit risk could mean a potentially significant change from current practice, particularly for sales to entities with higher risks of default. The revenue recognised in those cases is likely to differ from the consideration collected. The difference between revenue and the amount collected will be recognised as a finance gain or loss. The amount of estimated credit losses is a reduction of revenue. If the total amount is collected, the credit loss amount becomes a finance gain.

IFRS today requires economic benefit to be probable for revenue to be recognised. This criterion prevents recognition of revenue when sales are made to high-credit risk customers. Revenue is recognised only when the benefit becomes probable, which may be when the customer paid.

The expected model will require the transaction price to be adjusted to reflect the customer's credit risk rather than delaying revenue recognition. When the entity satisfies a performance obligation, it recognises revenue for the amount it expects to collect – that is, the probability-weighted expected amount. Subsequent assessments of the customer's ability to pay are recognised separately from revenue.

#### Next steps

This project is a complete overhaul of current revenue guidance, and there may be other areas of the proposed model that may have impacts on retail and consumer entities. For example, the proposed standard will also contain guidance on the impact of offering options and renewals to customers and accounting for free or discounted products. Recognition upon transfer of control rather than transfer of risk and rewards could also impact some transactions.

Management should continue to track the Boards' proposals. The Boards expect to issue an exposure draft in the second quarter of 2010. The comment period is likely to be four months. There may therefore be a new standard by the middle of 2011 with a likely effective date no earlier than 2014.

We encourage companies to take the time to assess the Boards' proposals and understand the impact on current transactions and business practices. If there are aspects of the model that companies think should either change or be clarified, management is encouraged to provide suggestions for improvements as part of their comments to the Boards' proposals.

This article highlights just two of the projects currently in process at the IASB. There are several others in process, and many of them may also impact retail and consumer entities. These include projects on joint ventures, pensions, provisions, financial statement presentation and financial instruments, including hedging. Some of the projects are expected to be completed within the next 12 months (joint ventures and provisions), with all of the others planned to be completed by 2011.