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Consumer Business

On your marks!

Just how ready is the retail industry for IFRS?

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Still some work left to do!

The impact of the application of International Financial Reporting Standards (IFRS) will be far reaching for retailers. As well as impacting reported performance and analysts' and commentators' perceptions, they will significantly affect accounting systems, employee compensation, mergers or acquisitions, possibly tax, and many other areas. All this means that preparing for IFRS needs to come high up every Chief Financial Officer's agenda. And time is running out.

Most listed companies in the European Union will have to apply IFRS for annual periods beginning on or after 1 January 2005. The changes could have unexpected effects on financial performance reporting.

To support our retail industry clients in meeting this major challenge, Deloitte created a dedicated European workgroup, aimed at ensuring we provide pragmatic and internationally consistent recommendations on the application of IFRS. As part of its remit, the workgroup carried out a pioneering benchmarking study. Our aim was to discover:

- How ready large European retailers are for IFRS?
- The preferred accounting options retailers are contemplating to adopt when available to meet the challenges raised by the new standards?
- Whether those solutions are appropriate and workable?
- Whether there is consistent understanding of the application of IFRS across the industry?

The conclusions of the benchmarking are startling.

- **The European retail industry may not yet be fully ready for IFRS**
  As in most other industry segments, very few of the major retailers we spoke to would be fully IFRS compliant if they maintained their current practices! Although some retailers believe that they have done all that's needed to comply with the new regulations, others had not completed all the necessary steps towards meeting the new regulatory requirements at the time we carried out our analysis during the summer. Based on this, we believe a significant proportion of retailers still have work to do if they are to meet IFRS deadlines.

- **Some retailers have underestimated the scale of the work needed to prepare for certain aspects of IFRS**
  At the time of our study not all retailers had appropriate systems in place to be able to provide segment reporting information as required by IAS 14 or allocate vendor allowances to products in order to obtain appropriate 'cost of sales'. Furthermore, some companies have not yet carried out all the necessary financial simulations to evaluate the impact of changes on revenue recognition, impairment testing of their assets including brands under IAS 36, to give just a few examples.

- **If current practices are maintained, companies may find themselves applying the standards in very different ways**
  As the sample of the responses to our benchmarking questions demonstrates (see over), it seems that consistency would not be there between retailers in how they would apply the new Standards if they don't change their current practices in many business-critical areas.

- **IFRS standards do not just pose technical challenges for the industry, but also create stakeholder communication issues**
  Retailers may be caught up in dealing with the technicalities of changing their financial reporting. In many cases these changes will have a profound impact throughout their accounts. One of the most important tasks will be to communicate the reasons for those changes and their impact on the operational reality of the business to stakeholders. Our research indicates that planning this kind of communication is well down most retailers' priority lists. But the potential impact on market sentiment and valuations could be significant, especially if there is a risk that the investment community may not properly understand what the changes mean!

Deloitte retail IFRS working group

Acknowledging the fact that IFRS has some very specific implications for the retail industry, Deloitte established a dedicated European working group, bringing together consumer business experts and IFRS specialists from five European countries. The group concentrated on assessing the implications of introducing IFRS, both in conceptual terms and, more importantly, in finding pragmatic recommendations. The group's work focused on those Standards that it identified as raising issues very specific to the retail industry: around a quarter of the Standards applicable in 2005. Other Standards may have significant effects on the retail industry (such as accounting for employee benefits or financial instruments) but the application issues are generally common to many industries. We address them through our network of Deloitte IFRS specialists and other Deloitte industry IFRS working groups.

Key accounting challenges for the industry

Many of the issues raised by IFRS are common to all industries, but a few have important industry-specific dimensions. Each of them is particularly relevant to the retail industry.

- IAS 2 Inventories
  Inventories need to be valued in a manner consistent with the determination of the cost of goods sold. According to IAS 18, incorporating vendors' allowances into the cost of goods sold will reduce the carrying amounts of inventories and impact margins.

- IAS 14 Segment reporting
  Presenting performance by segment is a particularly sensitive issue in the industry. This Standard appears to put mono-format specialist retailers at a disadvantage, since they will have to disclose more detailed information about their business than multi-format retailers.

- IAS 16 Property, plant and equipment
  Many retailers face difficulties in determining the useful life of assets due to the inherent uncertainty of retail formats' future business performance, as well as the difficulties of assessing residual values in notoriously subjective property markets.

- IAS 17 Leases
  Retail is one of the largest occupiers of property in Europe. Leases need to be assessed as to whether they are finance or operating leases. In addition to the consideration of the contractual terms, the substance of those lease contracts needs to be appreciated to identify the appropriate accounting treatment.

  For leases that exist at the date of transition to IFRSs, this exercise may be quite difficult because companies will have to take into account solely the information that was available at the inception of the lease.

  Lease incentive payments also need to be reviewed to ensure that their effects have been considered all over the lease term.

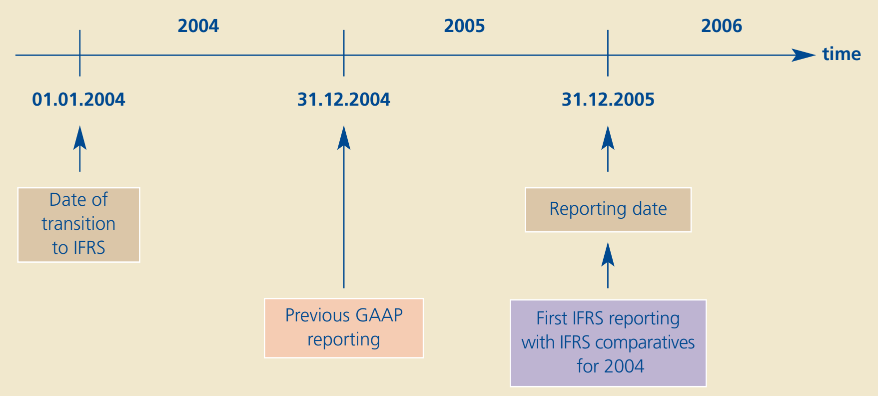
- IAS 18 Revenue
  The key questions are "How much is it?, and, when should it be recognised?". Sales revenue is **the** key determinant of retail performance and many existing practices will not be allowed.

  Arrangements between vendors and retailers follow very different formulae. This may significantly impact revenue recognition and the measurement of the cost of sales, both for retailers and vendors. The cost of loyalty programmes needs to be recognised when sales are recognised in many cases as a reduction of retailers' revenue. Revenue recognition resulting from sales activities generated from space concessions to vendors or from reselling of services when retailers have an intermediary role will change dramatically and will affect first-year revenue comparison.

- IFRS 3 Business combinations, IAS 38 Intangible assets
  Retailers buy, sell and grow brands. But how should they be accounted for? The challenge is to identify the nature of intangible assets that are acquired in a business combination in an appropriate way and segregate brand value, customer assets, catchment areas … in the way that IAS38 appears to demand that they are identified and valued.

- IAS 36 Impairment of assets
  Every retailer has underperforming assets. The toughest challenges are likely to be for retailers, to set up adequate procedures to identify impairment indicators, to establish the annual impairment tests on goodwill and intangible assets with an indefinite useful life and to define the cash-generating unit (CGU) at which non-current assets and goodwill are regularly tested for impairment. What level of detail will be required? For example, will retailers need to go down to country, region, store or department level for the identification of CGUs?

Opening IFRS balance sheet approach



Benchmarking the retail industry

Deloitte completed this confidential survey in Summer 2004, involving eight of Europe's largest retailers.

Our approach involved:

- establishing a series of questions relating to the application of the new international accounting standards mostly relevant to retailers;
- selecting a representative group of European retailers, including mass market, specialist, food, non-food, global, non-global, listed, and private companies. The chosen companies have headquarters in five European countries and operations all over the world;
- Comparing current local GAAP practices with the required IFRs treatments, as well as, to the extent available, collecting comments and considerations from retailers on the application of IFRS.
- analysing the results of our findings to identify areas of convergence or divergence and to understand the rationale supporting the retailers' points of view.

Different interpretations of the new Standards:
As you can see from this list of typical questions from our benchmarking, diversity may arise in the application of the new Standards if existing practices do not change:
*Each letter represents one retailer questioned during the benchmarking

Relevant standard	Illustrative question	Retailer responses* A	B	C	D	E	F	G	H	Deloitte point of view
IAS 2 Inventories	Are unrealised vendor allowances (such as trade discount, rebates and similar items) deducted from your inventory value under your local GAAP?	Yes	Yes	Yes	No	Yes	No	No	No	More consistency between stock and cost-of-sales valuation is required in the way vendors' allowances are accounted for.
IAS 14 Segment reporting	Do the disclosed segments under your local GAAP meet the definition of a reportable segment under IFRS?	No	Yes	No	Yes	No	No	Yes	No	Retailers need to be prepared to communicate externally information previously kept confidential.
IAS 18 Revenue	Are vendor allowances currently added to revenues in your local GAAP?	No	No	No	No	No	Yes	Yes	Yes	In most cases, vendor allowances cannot be included in revenue. Retailers will need to explain the anticipated reductions in revenue.
IAS 36 Impairment of assets	Do you consider an individual store to be a CGU when testing it for impairment under your local GAAP?	No	Yes	Yes	Yes	No	N/a	No	N/a	In most cases the store will have to be considered to form a CGU when testing the store for impairment.

Key IFRS issues for retailers

The new regulations will have a significant impact on a wide range of accounting and business issues for retailers. The following four areas illustrate just some of these issues.

Key: Issue identified during benchmarking as:

- Extremely important
- Very important
- Quite important

"Retailers are reluctant to disclose sensitive information that could impair their competitive position."

IAS 14 Segment reporting

According to IAS 14, entities need to disclose specific financial information for business and geographical segments that are identified based on different risks and returns. Two or more internally reported business segments or geographical segments may only be combined as a single business or geographical segment if they show similar long-term financial performance and they are similar in all of the factors as indicated in the definition of a segment. The existence of significant active synergies between two business entities may indicate that they can be grouped together if the results of one entity cannot be understood without the results of the other.

Specialist, mono-format retailers are faced with the problem that they may have to disclose more layers of information about their business than their multi-format competitors. They claim that this put them in an unfair situation as far as external communication of performance is concerned.

The Deloitte view: Unfortunately there is no alternative available to retailers under this standard.

Retailers are reluctant to disclose sensitive information that could impair their competitive position.

The Deloitte view: The Standard includes some thresholds to be met before detailed information is disclosed. It is nonetheless true that IFRS requires further transparency.

Many retailers' information systems lack the capacity to provide selective income statement and balance sheet information segment.

The Deloitte view: Companies in this position urgently need to develop a plan to comply with IAS 14. Time is running out!

IAS 16 Property, plant and equipment

IAS 16 sets out the way that companies must account for property, plant and equipment. This includes initial recognition at cost and subsequent measurement at cost or revalued amount. Depreciation methods should reflect the pattern by which each asset's economic benefits are used up by the company. The retailers in our benchmarking were concerned about the following:

Retailers are unclear about how to estimate the useful life of an asset, due to the business uncertainty of retail formats.

The Deloitte view: We believe that economic considerations should drive decisions on this, ahead of any tax dimensions. Retailers can also justifiably set a short life-span for emerging concepts, formats and channels to market.

It will be difficult to make accurate assessments of residual values, because of contrasting views about the property market in different store locations.

The Deloitte view: Retailers need to consider the various local regulations governing the opening of retail space – as well as property market economics – to define a specific residual value accounting policy for their enterprise.

It appears that some retailers are planning to adopt a policy of revaluing their property, plant and equipment at the point where IFRS is implemented for the first time under IFRS 1 and going forward, under IAS 16, while others will not do so.

The Deloitte view: While under IFRS 1, at the date of transition to IFRS, any item of property, plant or equipment can be revalued at its fair value, adoption of a revaluation policy going forward must result in regular remeasurements. Notably, a revaluation policy can be implemented on an optional basis by class of assets, such as land only. This reduces some of the complexities of the revaluation treatment and its future impact on net income.

IAS 17 Leases

This Standard looks at the arrangements between lessors and lessees of assets. It sets out clear guidance as to the accounting for transactions between them.

- Many companies currently believe that the impact from the switch from their local GAAP to IFRS on leases would be minimal. However, the detailed requirements of IAS 17, including the need to split the land and buildings elements of the contracts as well as the consideration of the substance of the arrangement and not just its form, may lead to different conclusions.

  The Deloitte view: Although the introduction of IFRS could be seen as a good opportunity for some retailers to revalue their property portfolios we would expect many to be able to conclude that existing operating leases can continue to be accounted for in a similar way to existing GAAP. In the longer term we expect an IASB project conclusion that may move most of these leases on the balance sheet. Retailers' property strategies should take account of these short and long-term changes.

"In the longer term we expect an IASB project that may move more of these leases onto the balance sheet."

IAS 18 Revenue

IAS 18 sets out specific requirements as to when revenue arising from sales of goods or provision of services should be recognised.

- Many revenue streams for multiple services provided by vendors to retailers have been accounted for pragmatically in the past as revenue. Although it is still not particularly precise, IAS 18 forces retailers to question whether they should now consider these services as cost reductions rather than revenue. Applying this standard would therefore lead to a reduction in revenues, without necessarily affecting margins.

  The Deloitte View: We think that IAS 18 makes it clear that in most cases retailers should consider these services as cost reductions. We would expect most retailers to show a reduction in revenues as a result of the application of IAS 18.

- There is a lack of clarity as to how retailers' loyalty points should be accounted for. Retailers are also unsure whether to account for their loyalty programme as a revenue reduction or a cost reduction.

  The Deloitte View: Retailers should recognise loyalty points as soon as they are granted, taking statistical redemption rates into account. Loyalty programmes should generally be treated as revenue reductions. However, if they are financed by vendors, the retailer may not have to reduce revenue.

- Retailers often play the role of an 'agent' when they offer their retail space to vendors under concession arrangements or when they act as intermediaries, for example selling travel services or mobile phone airtime contracts. Under IAS 18, if retailers act as an agent, they will only be able to include the commission associated with the service they provide in their revenues.

  The Deloitte View: This may have a significant impact on revenue figures for the affected businesses. Retailers will need to plan and deliver a focused communication programme to the financial community, well in advance of the change.

"European retailers should not underestimate any of the issues set out here. Indeed this is just a snapshot of the much wider changes that the adoption of IFRS will bring about. Some may not have realised just how much work they still have to do."

Other ones to watch

The impact of IFRS on retailers could be surprisingly far-reaching. While segment reporting and accounting for property, leases and revenues may be some of the main areas of concern, the introduction of IFRS raises many other issues.

IAS 2 Inventories

This Standard provides guidance on: determining inventory cost; the cost formulae that should be used to assign costs to inventories when specific identification is not appropriate; when and in what circumstances inventories should be expensed; and inventory write-downs. Retailers seem to identify the main implementation issue as one of further disclosures, as well as requirements on a consistent determination of the cost of inventory.

The Deloitte view: Retailers urgently need to investigate the additional disclosure requirements and compare them to local practice. They also need to determine an acceptable method for assessing the cost of inventory and apply it consistently.

IFRS 3 Business combinations

All business combinations will need to be accounted for by applying the purchase method. The acquirer shall recognise the target's identifiable assets, liabilities and contingent liabilities at their fair value on the acquisition date, and also recognise goodwill, which is subsequently tested for impairment on an annual basis rather than being amortised. Some retailers are concerned by the non-amortisation of goodwill and the possibility of ending up at the date of acquisition with an excess in the fair values of identifiable assets, liabilities and contingent liabilities over the cost of acquisition (previously called 'negative goodwill').

The Deloitte view: Effectively, recognised goodwill shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that an impairment is needed. Any excess in the fair values of identifiable assets, liabilities and contingent liabilities over the cost of acquisition needs to be recognised immediately in the income statement.

IAS 36 Impairment of assets

This Standard sets out how businesses must ensure that their assets are carried at no more than their recoverable amount. It also specifies how to determine recoverable amount. The greatest issues appear to be around the definition of impairment indicators, the frequency of impairment tests and the grouping of assets to form cash-generating units (CGUs). It could also prove hard to determine the carrying amount of CGUs and allocate corporate assets to each CGU.

The Deloitte view: It is important to identify external and internal sources of impairment specific to each enterprise, as well as the frequency and scope of tests. We also recommend that retailers develop a reasonable and consistent method of asset allocation.

In terms of determining the carrying amount of a CGU, retailers must be careful that this is determined in a way that is consistent with how the recoverable amount of the CGU is assessed. This includes paying particular attention to the extent to which provisions for employee benefits and restructuring costs are dealt with in the impairment calculations.

Next steps

Retailers need to take a pragmatic approach to ensuring that their business is compliant with the IFRS requirements.

Act sooner rather than later

Each retailer will be affected differently. You need to understand the implications well before the January 2005 deadline, to allow your company enough time for any projects or restructuring. Don't forget, 2005 numbers and 2004 comparatives will need to be audited. Shareholders and analysts have begun to ask questions already. Finance Directors are asking their teams to analyse the numbers in more detail.

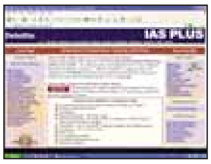
Manage expectations

Once you've assessed the likely impact of IFRS, you will need to communicate with those relying on your financial statements – such as shareholders, bankers and analysts – to avoid surprises. Other things to include in your IFRS strategy are tax, training, remuneration, IT and regulatory implications.

Tackle the whole picture

Although there is a huge wealth of technical literature available about the implementation of IFRS, it's vital to recognise that the implications are not simply technical. Choose your advisor carefully. They need to understand the specific business issues, the change in management, stakeholders communication and tax implications, as well as the accounting and financial reporting impact.

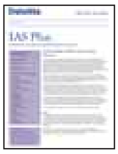
Deloitte Touche Tohmatsu has a range of tools and publications to assist companies in implementing and reporting under International Financial Reporting Standards. These include:



www.iasplus.com
Updated daily, iasplus.com is your one-stop shop for information related to IFRS.

Model IFRS Financial Statements
Published annually, it provides practical guidance for the application of IFRS in preparing financial statements.

IFRS In Your Pocket
Published in English, Finnish, French, Polish and Spanish, IFRS In Your Pocket provides summaries of each IFRS.



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For more publications related to IFRS, visit
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About Deloitte

Deloitte helps leading global household name retailers to address accounting, tax and business performance issues.
In particular, we are leading the debate globally around IFRS and its implementation, and working with clients in all sectors of consumer business to plan and prepare for its introduction. Our IFRS champions across Europe form a permanent team, meeting and communicating regularly to exchange experience, resolve complex issues and ensure that the firm has a consistent position on IFRS issues and articulates that position with our clients and international standards bodies.

The Deloitte firms around Europe are members of Deloitte Touche Tohmatsu, an organisation of independent member firms devoted to excellence in providing professional services and advice, with around 120,000 people in over 140 countries.

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