EXECUTIVE SUMMARY

The Application of IFRS: Retail companies

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Foreword

It’s an important time for the IASB and International Financial Reporting Standards. The Board is committed to completing its four high-priority projects on which it is collaborating with the FASB: financial instruments, insurance contracts, leases and revenue recognition. In the meantime, the Board has finalised its consultation on the future agenda and set out priorities for the work programme. And all the while, the list of countries adopting IFRS continues to grow.

The retail sector is influenced by global and local demand, global economic performance, global trends and the adoption of international standards. Retailers are facing a number of trends and forces that will have significant impact on the sector. Economic, social, cultural and demographic shifts are fundamentally changing consumer behaviour. Technologies – the web, social media and mobile – are influencing how consumers view stores and brands, and how they make their buying decisions. Technology is also providing opportunities to retailers to get closer to their customers and to improve their operations. Developed markets are growing slowly while emerging markets are experiencing tremendous growth. And regulation is impacting the retail sector more than ever before.

Our survey discusses many of the key sector accounting issues and provides illustrations of how retailers have sought to address them. The excerpts in our full survey illustrate examples of sector-specific accounting disclosures, including in some cases detailed explanations of the business context in which accounting judgements have been made. For companies already applying IFRS, it gives some idea of the extent of consistency within the sector; for companies that haven’t yet adopted IFRS, it gives some idea of what your reporting future might be.

We are pleased to publish this executive summary of our survey of the application of IFRS in the retail sector. We hope that this publication serves as a useful resource for both existing users of IFRS and retailers seeking to understand the potential impact of adopting IFRS.

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About this executive summary

This executive summary has been drawn from our publication *The Application of IFRS: Retail companies*, and focuses on the results of a survey of the IFRS financial statements of 27 companies in the retail sector across 13 countries. This publication has been produced by the KPMG International Standards Group, in collaboration with KPMG in Japan and KPMG in France.

This executive summary should be read in conjunction with that publication in order to understand more fully the findings from the survey. In addition, that publication includes disclosures made by retailers in their consolidated financial statements that we believe may be useful in assessing the type of information being disclosed in practice. That publication also includes a chapter on significant differences between IFRS and US GAAP in respect of the issues discussed.

IFRS-related technical information is available at www.kpmg.com/ifrs.

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG’s Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today’s dynamic environment. For a free 15-day trial, go to www.aro.kpmg.com and register today.

Our Global Retail Practice

KPMG’s Global Retail practice professionals have the knowledge, experience and skills to help clients succeed in the highly competitive and rapidly changing retail sector.

Through our international network of member firms, we serve retail companies worldwide. We offer a number of services that are focused on helping our clients address the issues facing their sector, in the key areas of governance, performance and growth.

For more information, visit www.kpmg.com/retail.
Revenue

In the retail sector, revenue is one of the most important figures in communicating company performance to stakeholders. Some may think that revenue accounting should be simple for a retailer, given that a large number of transactions in the sector is carried out and recorded on a ‘cash basis’. However, the number of accounting issues facing retail companies should not be underestimated. One of the challenging areas is accounting for sales incentives, including various customer loyalty programmes, discounts and vouchers. The accounting for sales incentives under IFRS has become more prescriptive in recent years, and it is interesting to see the disclosures that retailers include in their financial statements.

Key messages from our survey group

- All companies provided a generic revenue recognition policy for the sale of goods, with the most common specific policies relating to items excluded from revenue, sales incentives and returns.
- Nearly half of companies reported revenue from rendering services, which included revenue from extended warranties.
- A quarter of companies disclosed an accounting policy for and/or a breakdown of franchise-related sales.
- All companies that identified more than one reportable segment provided detailed disclosure of revenue within their segment note. All companies whose operating segments were not organised by product presented a separate breakdown of revenue by types of products or services.

Other areas that may cause issues in revenue recognition by retailers include returns, warranties and sales taxes or duties.
Inventory

The procurement and management of inventory is one of the most important factors for the success of retailers. Typically retailers carry a large volume of inventory, catering for the various and changing needs of different consumer groups. Some retailers track customer demand on a daily basis to ensure sufficient stock levels in different stores. Some goods sold by retailers have limited shelf life, some are exposed to changes in fashion and demand, and most goods are subject to competitor price pressure. All of these risks require a regular review of inventory for any signs of impairment. Other challenges for retailers include the treatment of allowances received from suppliers and inventory costing.

Key messages from our survey group

- While all companies disclosed an accounting policy for inventory, the level of detail in the disclosures varied.
- Nearly all companies disclosed their inventory costing policy. While weighted-average cost and first-in, first-out were the most common methods, several companies applied the retail method.
- Just over half of companies disclosed a provision for the obsolescence of inventory at the end of the reporting period; however, the amounts of the provision were generally not significant.
Property, plant and equipment and investment property

Customer demographics in different locations vary and the selection of store locations is one of the key factors for the success of a retailer. A retailer usually has an investment plan for each location in which it operates, including its strategy either to buy or lease properties. While there are no significant differences between buying and leasing from an operating perspective, the impact on the balance sheet under current IFRS may be significant if a retailer rents stores under operating lease contracts that qualify for off-balance sheet treatment – i.e. operating leases.

Key messages from our survey group

- Property, plant and equipment represented more than 20% of total assets for over three-quarters of companies, and more than 70% for a third of companies.
- All companies applied the straight-line method of depreciation. The useful lives of property, plant and equipment of a similar nature varied widely between companies.
- All companies applied the cost model for the subsequent measurement of property, plant and equipment, with one company applying the revaluation model to some of its assets.
- In general, the amount of assets leased under operating leases and not recognised on-balance sheet was material in proportion to total assets.
- The majority of companies had investment property on their balance sheets; two-thirds of companies applied the cost model for the subsequent measurement of investment property.
Business combinations

The level of business combinations in the retail sector often depends on the nature of a retailer’s operations. Larger department stores are more likely to expand organically than chain stores. The drivers behind this activity include opportunities to consolidate market share, and to expand geographically into new markets.

The quantity and size of business combinations is closely related to the companies’ financial condition. In recent years, a tightening capital market and economic downturn have reduced the ability of companies to secure the required funds. Not surprisingly, while more than half of the companies included in the survey had a business combination during the period surveyed, the size of the acquisition was often not significant.

Typically, the most challenging issue for a retailer in accounting for a business combination is identifying intangible assets not previously recognised by the acquiree, such as internally generated brands and customer-related intangible assets.

Key messages from our survey group

• All companies disclosed an accounting policy for business combinations.
• While two-thirds of companies disclosed a business combination in the period surveyed, generally the size of the acquisitions was not significant.
• For just over a third of companies, the proportion of the balance of goodwill to total assets was less than 5%.
Intangible assets

Intangible assets are key to the success of retailers, in particular brands and trademarks, and customer-related intangible assets. However, while intangible assets feature predominantly in the annual reports of retailers, they tend not to be one of the largest items on a retailer’s balance sheet. One of the reasons is that intangible assets generally have a high recognition threshold, which is usually met when they are acquired, either directly or in a business combination, rather than when they are generated internally.

Retailers frequently enter into agreements for the use of brands and trademarks in order to expand their business. In particular, this is often seen in the luxury goods market and amongst retailers with a franchise business model.

Key messages from our survey group

- The proportion of intangible assets to total assets was generally not significant.
- The most common intangible assets recognised on the balance sheet related to software, while the most significant balances related to brands, trade names or trademarks and licences.
- All companies that discussed the amortisation of intangible assets applied the straight-line method. The useful lives of intangible assets of a similar nature varied widely between companies.
- The majority of companies were silent on the amounts of internally generated intangible assets recognised.
Impairment of non-financial assets

In the business environment of the last few years, impairment testing has come into sharp focus across all industries. Impairment testing relies heavily on discounted cash flow projections, and requires considerable judgement. Another key aspect of impairment testing for retailers is the identification of cash-generating units (CGUs), which is based on assets that generate cash inflows that are largely independent of the cash inflows of other assets.

Key messages from our survey group

- A small majority of companies disclosed how CGUs were determined. However, the disclosure did not always extend to company-specific facts and circumstances.
- A majority of companies recognised an impairment loss in the period surveyed.
- The most commonly impaired asset was property, plant and equipment, although impairment losses generally were not significant compared with the carrying amount of the assets written down.
- Value in use was the most common approach in determining recoverable amount. The most common period for projecting future cash flows was 5 years. The description of the rate used to discount future cash flows varied widely, although the majority of companies mentioned adjustments for sector- or country-specific risks.
- Less than half of companies recognised a reversal of an impairment loss in the period surveyed. Reversals mainly related to property, plant and equipment.
Provisions and contingencies

Retailers are exposed to a variety of risks in their day-to-day operations and from historical activities that might result in future cash outflows. These risks frequently relate to the products sold, litigation from competitors and customers, obligations in connection with various restructuring programmes, and store closures.

Under IFRS, there are strict criteria to be met before a provision for restructuring can be recognised, as well as detailed disclosure requirements about the nature of the obligation and the timing of expenditure.

Key messages from our survey group

• All companies disclosed their accounting policy for recognising provisions.
• The most frequently disclosed provisions related to restructuring, onerous contracts and costs to decommission or close stores.
Employee benefits (defined benefit plans)

Developing appropriate estimates and accounting for defined benefit obligations can be a particularly complex area for a number of reasons. The worldwide nature of most companies’ operations requires the development of assumptions that can vary widely between jurisdictions due to differences in anticipated salary inflation, retirement age, return on assets and discount rates.

The IASB issued an amendment to IAS 19 Employee Benefits in June 2011, effective for annual periods beginning on or after 1 January 2013. This amendment requires immediate recognition of defined benefit costs, modifies the treatment of taxes payable and administrative costs incurred in maintaining the plan, and introduces enhanced disclosures about defined benefit plans, among other changes.

While this amendment will impact all sponsors of defined benefit plans, it will particularly impact the balance sheets of those retailers that currently amortise actuarial gains and losses using the corridor method.

Beyond the accounting, the amendment could impact debt covenant tests and it may be necessary to discuss with lenders revisions to relevant covenants included in lending agreements.

Key messages from our survey group

• Over two-thirds of companies sponsored a defined benefit plan; in all cases the plan was a pension scheme.
• Of these companies, three-quarters funded more than 50% of the present value of the defined benefit obligation.
• The majority of these companies recognised actuarial gains and losses immediately in other comprehensive income. This will be the treatment required under the revised standard on employee benefits that came into effect in 2013.
Financial instruments (hedging)

Most large retailers tend to have a number of foreign operations, and are involved in various investing and financing activities, which expose them to a variety of financial risks. These risks include credit risk, market risk (currency risk, interest rate risk and commodity risk) and liquidity risk. Derivatives are frequently used to manage these risks.

Various factors influence a retailer’s hedging strategy, including the company’s risk management objective, the company’s risk appetite, the general economic outlook and the retailer’s funding structure.

These wide-ranging factors mean that hedging and risk management activities vary from retailer to retailer, not just in terms of the type of risks being managed, but also in terms of the specific instruments that they use for the purpose of achieving their objectives.

Key messages from our survey group

- All companies discussed their exposure to credit risk, liquidity risk, interest rate risk and foreign exchange risk.
- Over three-quarters of companies applied hedge accounting. All of these companies hedged foreign currency risk and a large majority also hedged interest rate risk.
- All companies that applied hedge accounting used cash flow hedging and over half of them used fair value hedging.
Interests in joint ventures (joint arrangements)

Retailers often enter into collaborative arrangements in order to expand their business, either into new markets or in terms of product offering. Collaboration can take many forms, including joint ventures.

Under IFRS, there are strict criteria that must be met in order for joint venture accounting to be applied, and when a retailer refers to an operational involvement in a joint venture it does not necessarily follow that the arrangement will be accounted for as a joint venture in accordance with IAS 31 Interest in Joint Ventures.

In May 2011, the IASB published IFRS 11 Joint Arrangements, which requires companies to evaluate the contractual rights and obligations agreed to by the parties to joint arrangements; the legal form of the arrangement is no longer the most significant consideration in determining the accounting for joint arrangements.

The new standard requires that a company recognise an interest in a joint venture, previously a ‘jointly controlled entity’, using the equity method. Unlike IAS 31, proportionate consolidation is not permitted as an accounting policy choice.

Key messages from our survey group

- Two-thirds of companies disclosed an accounting policy for joint ventures. Most joint ventures were in the form of jointly controlled entities.
- Nearly two-thirds of companies with an interest in a jointly controlled entity applied the equity method. Proportionate consolidation, which was used by the remaining companies, will no longer be permitted as an accounting policy choice under the new standard on joint arrangements that came into effect in 2013.
Operating segments

Communicating a company’s performance to shareholders is a challenge, requiring disaggregation to explain the trends and results that have been affected by different factors or that have different prospects. Retailers are used to discussing their performance on a disaggregated basis in the narrative sections of their annual reports. These sections are often relatively free-form, allowing flexibility to management to choose the most appropriate way to describe their business.

Retailers may have diverse operations and operate in various geographical locations. Also, large retailers sometimes have several different types of operations, such as property management and financial services, in addition to different types of retail operations. Thus there is a wide variety in practice in terms of segment reporting among retail companies.

The application of IFRS 8 Operating Segments across a selection of industries is considered in depth in our publication The Application of IFRS: Segment reporting.

IFRS 8 sets out the requirements for the disclosure of information about a company’s operating segments using a ‘management approach’, both in regard to the identification of reportable segments and the measures disclosed for those segments – e.g. the disclosed segment result is the measure used by management to make decisions. This approach is an opportunity for companies to communicate with their shareholders based on the information they use internally, enabling greater alignment of narrative explanations and the financial statements themselves.

IFRS 8 requires segment disclosures based on the components of the company that management monitors in making decisions about operating matters. Such components (operating segments) are identified on the basis of internal reports that the company’s chief operation decision maker (CODM) reviews regularly in allocating resources to segments in assessing their performance.

Key messages from our survey group

- Over half of companies discussed how the CODM was identified. In most cases, the role of the CODM was performed by a body or a group of individuals.
- Most companies had more than one reportable segment. Just over half of these companies identified their segments based on products and services, and presented additional geographical information as part of their entity-wide disclosures.
- The most common range of reportable segments was 3 to 5.
- Almost all companies disclosed the segments’ measure of profit or loss, with operating profit, EBIT, EBITDA and trading profit being relatively common.
Presentation of profit or loss and statement of cash flows

IFRS requires the following as a complete set of financial statements:

• a statement of financial position;
• a statement of profit or loss and other comprehensive income (OCI), presented either in a single statement or in the form of two statements, being an income statement (which displays components of profit or loss) followed immediately by a separate statement of comprehensive income (which begins with profit or loss as reported in the income statement and displays components of OCI to sum to total comprehensive income for the period);
• a statement of changes in equity;
• a statement of cash flows, in which cash flows from operating activities can be presented using either the direct or indirect approach;
• notes, comprising a summary of significant accounting policies and other explanatory information; and
• a statement of financial position as at the beginning of the preceding comparative period when a company restates comparative information following a change in accounting policy, correction of an error or reclassification of items in the financial statements.

All financial statements within a complete set of financial statements are presented with equal prominence. The above statement names are not mandatory and alternatives are common – e.g. balance sheet.

Key messages from our survey group

• Most companies presented their performance using two statements: an income statement and a separate statement of comprehensive income.
• The majority of companies presented expenses by function on the face of the income statement or statement of profit or loss and OCI.
• Most companies presented cash flows from operating activities using the indirect method.
Performance measures

Retailers use a wide variety of KPIs to measure both financial and operating performance. Often these indicators are intended to provide meaningful insights to shareholders and analysts about the financial health and social responsibility of the company, and represent measures emphasised by the investor community.

Whether in the management discussion and analysis (MD&A), part of a board report, within commentary from company executives, or business overviews, all companies surveyed provided performance analysis as part of their annual reports. Though this analysis frequently focused on financial performance, varying degrees of emphasis were also placed on non-financial measures.

Key messages from our survey group

- Companies used a wide variety of performance measures. Indicators of financial performance were more common than indicators of operating performance.
- The most common indicators of financial performance included sales or revenue, earnings per share, EBITDA, capital expenditures and net debt ratios. The most common indicators of operating performance included the number of stores and total sales area.
- Over two-thirds of companies defined their alternative earnings measures and provided reconciliations to the amounts reported in the financial statements.
Critical judgements and key sources of estimation uncertainty

Retailers make a number of key estimates and judgements, some of which are sector-specific and others that apply across industries. One of the most important areas for retailers is estimates applied in impairment testing, which requires assumptions about future cash flow projections, expected future growth and the useful lives of assets, all of which are based upon strategic operating models and business decisions. Changing consumer behaviour and the rise of low cost competitors increase the difficulty of estimation.

Other areas frequently cited by companies in which management applies estimates are the useful life of property, plant and equipment and intangible assets, and employee benefits.

Key messages from our survey group

- Most companies presented separate note disclosure on critical judgements and estimation uncertainties.
- Impairment, the useful lives of property, plant and equipment and intangible assets, and employee benefits were the most commonly disclosed areas of critical judgements and key sources of estimation uncertainty.
Sustainability

The issue of sustainability is increasingly becoming top of mind for retailers. Whether sustainable initiatives are driven by regulators, shareholders, employees, customers or even competitors, companies of all sizes and in a wide range of industries are rapidly adopting business practices that will help sustain both natural and human resources.

Reporting on sustainable practices is also becoming prominent on corporate agendas. Establishing sustainable business practices seems to be only part of the challenge in sustainability initiatives. Reporting, however, is a challenge in itself.

Complex supply chains that many retailers rely on make it difficult to track and measure the true impact that a company has on its environment. A lack of standard measurements, or benchmarks for the sector, make it quite challenging to compare results within the sector.

Key messages from our survey group

- Most companies presented separate reports (sustainability or corporate social responsibility) or separate chapters in their annual reports on sustainability.
- Although a wide variety of areas was covered in sustainability reporting, the top issues highlighted were energy efficiency/consumption, and health and safety (employees).
- Just under half of companies with sustainability reporting disclosed their rating under the Sustainability Reporting Guidelines issued by the Global Reporting Initiative.
- Nearly two-thirds of companies obtained external assurance on their sustainability reporting.

In addition to understanding how to measure, many companies are also challenged to even understand what to measure. Although for some industries the metrics or KPIs that should be tracked are more obvious than others, for many, the choice of which metrics to track can run into the hurdles. Finally, once companies do establish their systems for tracking and measuring their KPIs, they are then faced with the challenge of effectively communicating the results to a wide range of stakeholders, each with their own unique agenda.
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