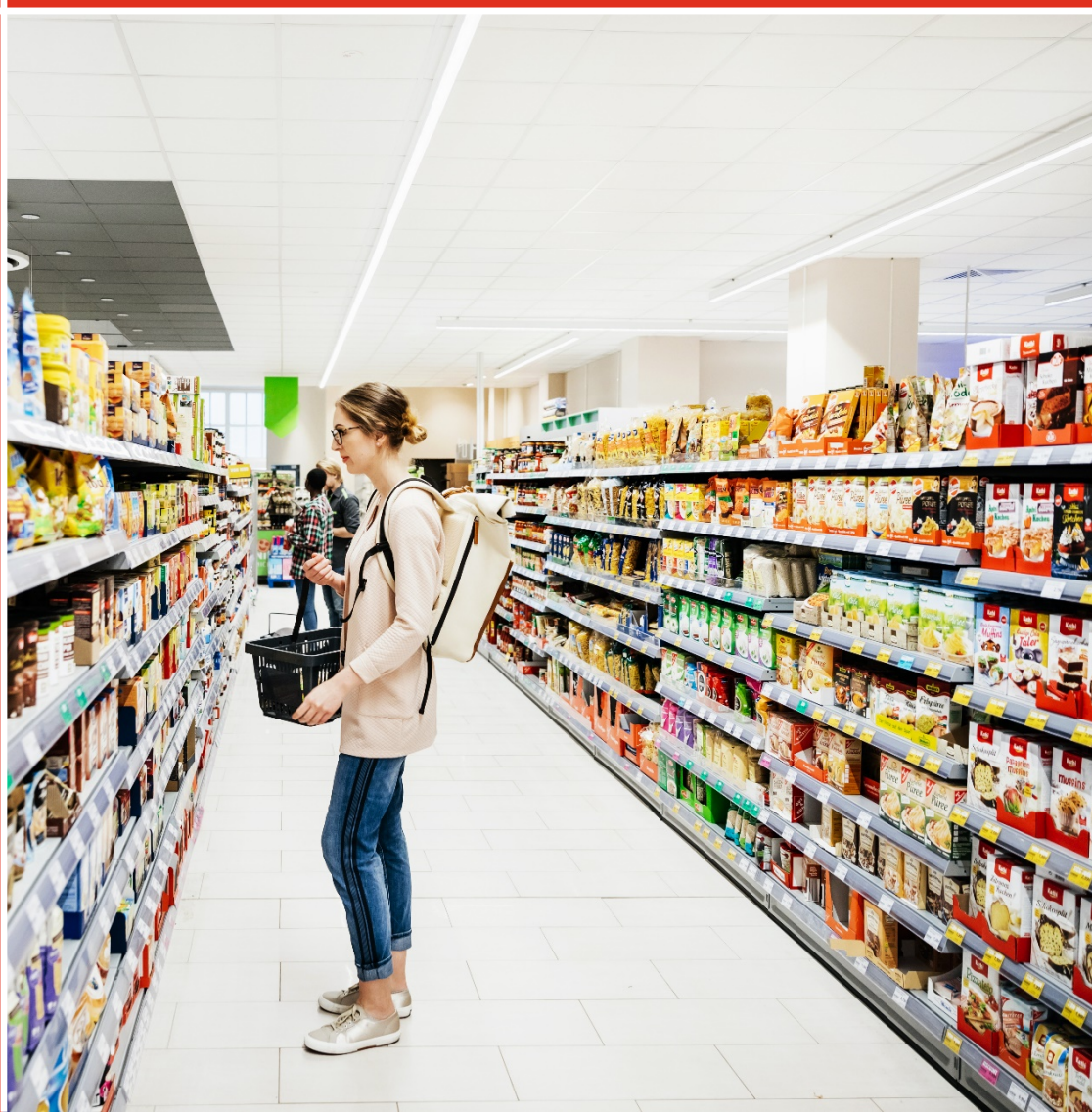


IFRS issues and solutions for the consumer markets industry

November 2021



Foreword

The **IFRS Issues and Solutions for the Consumer Markets Industry** is our collected insight on the application of International Financial Reporting Standards (IFRS) in this industry. The last publication of similar guidance was released in 2012. Since then, there have been significant changes to the industry and the adoption of some new accounting standards, in particular the adoption of IFRS 16, 'Leases', and IFRS 15, 'Revenue from Contracts with Customers'.

Most recently, during the pandemic, consumers have had to pivot and adopt new habits, many of which are sticking – signifying an historic and dramatic shift in consumer behaviour. We also know that consumers are evolving to be even more digital and eco-friendly. These changes continue to introduce complexity to the accounting for consumer products entities, including in particular as it relates to leasing arrangements, complex multi-party supply chains and impairment considerations.

We hope that you find this publication useful in understanding the accounting for common transactions. Each solution is based on a specified set of circumstances. Entities must evaluate their own facts and circumstances which might well differ from those in these solutions. The ongoing transformation of the industry might lead to variations, requiring an individual case-by-case assessment of the accounting implications.

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1

Revenue from the sale
of goods

1.1 Transfer of control to retailer

Background

Entity X, a consumer products company, enters into a contract with Retailer Y, a supermarket chain, to supply its products to the end-customers. Retailer Y receives legal title to the products and is required to pay for the products on receipt of the products from Entity X. Retailer Y has standard rights of return of the products, as set out in its contractual agreement with Entity X, as well as based on local statutory requirements.

Issue

When should Entity X recognise revenue?

Solution

Paragraph 38 of IFRS 15 requires an entity to consider certain indicators to assess whether control of the products has transferred. Since Retailer Y has physical possession of the products, holds legal title to the products and has a present obligation to pay for the products at the time of receipt of the products from Entity X, these are all indicators that control is transferred by Entity X when the products are delivered to Retailer Y.

A right of return is not a separate performance obligation, but it affects the estimated transaction price for transferred goods. Revenue is only recognised for those goods that are not expected to be returned by Retailer Y. Entity X needs to assess, based on its historical information and other relevant evidence, whether there is a minimum level of sales for which it is highly probable that there will be no significant reversal of cumulative revenue, because revenue needs to be recorded for those sales. [IFRS 15 App B para B23]. Based on historical information and other evidence, Entity X estimates that including 95% of its sales in the transaction price will not result in a significant reversal of cumulative revenue.

Revenue is recognised by Entity X for 95% of the sales on delivery to Retailer Y when control of the products is transferred. Revenue should not be recognised for the 5% of product sales, but Entity X should raise a refund liability and an asset (with a corresponding adjustment to cost of sales) representing the right to recover the products from Retailer Y. The returns asset will be presented and assessed for impairment separately from the refund liability. Entity X will need to assess the returns asset for impairment, and adjust the value of the asset if it is impaired (see FAQ 1.4 for more on right of return).

1.2 Sale of goods with a shipping service

Background

Entity X, an electronics manufacturer, has an arrangement with Retailer Y to sell televisions. Retailer Y requests Entity X to sell televisions and arrange for the shipping.

The contract states that legal title and risk of loss passes to Retailer Y when the televisions are picked up by the carrier at Entity X's shipping dock. Entity X is precluded from selling the televisions to another retailer (for example, by redirecting the shipment) once the televisions are picked up by the carrier at Entity X's shipping dock. Retailer Y concludes that it obtains control of the televisions when they are shipped.

Issue

How many performance obligations are in the arrangement, and when should Entity X recognise the revenue?

Solution

There are multiple promises in the contract, including the sale of televisions and shipping service. Entity X should determine whether these are separate performance obligations. [IFRS 15 para 22].

Entity X should assess the explicit shipping terms to determine when control of the goods transfers to Retailer Y and whether the shipping services are a separate performance obligation.

Shipping and handling services might be considered a separate performance obligation if control of the goods transfers to the customer before shipment, whilst the entity has promised to ship the goods (or arrange for the goods to be shipped) to the customer. In contrast, if control of a good does not transfer to the customer before shipment, shipping is not a promised service to the customer. This is because shipping is a fulfilment activity, because the costs are incurred as part of transferring the goods to the customer.

Performance obligations

Retailer Y can benefit from the televisions on their own without receiving the shipping service. Since control of the televisions transfers to Retailer Y when the goods are picked up by the carrier at Entity X's shipping dock before shipment, and Entity X has promised to arrange for the goods to be shipped, the shipping service is considered to be a distinct service, and so it is a separate performance obligation.

There are therefore two performance obligations in the arrangement: (1) sale of the televisions; and (2) shipping services.

Revenue recognition

Entity X should recognise revenue for the sale of the televisions when the televisions are picked up by the carrier at Entity X's shipping dock. This is because control of the televisions transfers to Retailer Y at that point.

Entity X should recognise revenue for the shipping services rendered as Entity X satisfies its performance obligations in terms of the contract. Since Entity X is arranging for the shipment to be performed by another party (that is, a third party carrier), it should also evaluate whether to record the revenue allocated to the shipping services on a gross basis as principal, or on a net basis as agent (that is, revenue recognised will only be the commission income received by Entity X).

1.3 Revenue from online sales

Background

An end-consumer decides to buy clothes directly on the website of a retail chain, Entity X. Full payment is made immediately online. The website proposes delivery to the end-consumer's home for an additional fee. Alternatively, the end-consumer can collect their purchases from any one of the chain's retail stores. Wherever possible, and in this case, the sale is honoured by Entity X using the store's inventory which is put aside immediately following the sale. The customer does not have the ability to change the shipping destination. They do not have physical possession and have not accepted the asset until it is received.

Customer A: Customer A opts for store pick-up and goes to the selected store to pick up the clothes one week after the payment is made.

Customer B: Customer B opts for delivery to their home for the additional fee.

Issue

When should the revenue be recognised by Entity X for Customer A and Customer B?

Solution

Customer A

Bill-and-hold arrangements arise where a customer is billed for goods that are ready for delivery, but the entity does not ship the goods to the customer until a later date. Entities must assess in these cases whether control has transferred to the customer, even though the customer does not have physical possession of the goods. Revenue is recognised when control of the goods transfers to the customer.

Paragraph B81 of IFRS 15 presents the following additional criteria that all need to be met in order for the customer to have obtained control in a bill-and-hold arrangement:

1. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);
2. The product must be identified separately as belonging to the customer;
3. The product currently must be ready for physical transfer to the customer; and
4. The entity cannot have the ability to use the product or to direct it to another customer.

In this case, Entity X has concluded that it is able to recognise revenue when the product (that is, the clothes) has been set aside specifically for Customer A. This is because the product is physically available at the pick-up location for transfer to Customer A, and the product cannot be used for another customer. Therefore, Customer A has obtained control over the product in this bill-and-hold arrangement.

If goods still need to be delivered from the warehouse, the bill-and-hold criteria will not be met until the store has received the product ordered by the end-consumer. Consideration might also need to be given to a 'returns' estimate that should include goods that are never claimed.

Customer B

Entity X should recognise revenue when the products are delivered. Although Customer B has paid for the asset at the time of purchase, they do not have the ability to direct the use of the asset until it is received. Indicators that control is transferred when the products are delivered include that the customer does not have the ability to change the shipping destination and that the customer does not have physical possession and has not accepted the asset until it is received.

1.4 Right of return

Background

Entity X

Entity X uses a retail network to supply its products to end-customers. Entity X sells 100 products to Retailer Y for CU50 each. The cost of each product is CU10. Revenue is recognised by Entity X at the point in time when Retailer Y obtains control of the products on delivery to Retailer Y.

Entity X estimates, based on the expected value method, that 6% of the products sold will be returned, and that it is highly probable that there will not be a significant reversal of cumulative revenue if the estimate of expected returns changes.

Retailer Y has a contractual right to return the products, for up to 120 days after Retailer Y has obtained control of the products, for a full cash refund. Entity X has no further obligations with respect to the products sold, and Retailer Y has no further return rights after the 120-day period.

Retailer Y

Retailer Y sells the products to end-customers through its retail stores. Revenue is recognised by Retailer Y when the product is sold at the store (that is, when the customer has obtained physical possession and has paid in full). Retailer Y has a returns policy which gives its customers a right to return the products for up to 90 days after the purchase.

Retailer Y estimates, based on the expected value method, that 10% of the products sold will be returned, and that it is highly probable that there will not be a significant reversal of cumulative revenue if the estimate of expected returns changes.

Issue

How should Entity X and Retailer Y recognise revenue in this arrangement?

Solution

Entity X

The right of return is not a separate performance obligation for Entity X, but it affects the estimated transaction price of the products sold. Paragraph B21 of IFRS 15 requires Entity X to recognise revenue only for those products that are not expected to be returned by Retailer Y.

Entity X estimates that including 94% (that is, excluding 6% of expected returns) of its sales in the transaction price will not result in a significant reversal of cumulative revenue. Therefore, Entity X recognises revenue for 94% of its sales to Retailer Y. Entity X should recognise a refund liability for the amount of consideration that it does not expect to be entitled to (that is, 6%), because it will be refunded to customers. The refund liability is remeasured at each reporting date to reflect changes in the estimate of returns, with a corresponding adjustment to revenue. A refund liability is an obligation to transfer cash. Therefore, refund liabilities do not meet the definition of a contract liability.

Entity X is also required to recognise a right to return asset, which represents the entity's right to receive goods (inventory) back from Retailer Y. The right to return asset is initially measured at the carrying amount of the goods at the time of sale, less any expected costs to recover the goods and any expected reduction in value. The right to return asset will therefore reduce the cost of sales. In some instances, the asset could be immediately impaired if the entity expects that the returned goods will have diminished, or no, value at the time of return.

The right to return asset is presented separately from the refund liability. The amount recognised as an asset should be updated whenever the refund liability changes and for other changes in circumstances that might suggest an impairment of the asset.

Revenue: Sales price per unit × number of units (excluding those expected to be returned):

(1 – 0.6 units)

Cost of sales: Cost per unit × number of units (excluding those expected to be returned):

CU10 × 94 units = CU940

Right to return asset: Former carrying amount per unit × number of units expected to be returned:

CU10 × 6 units = CU60

Refund liability: Return ratio × number of units sold × sales price per unit:

6% × 100 units × CU50 = CU300 for the refund obligation.

If Retailer Y did not have a contractual right to return the products purchased, but Entity X had a customary business practice of accepting returns, the right of return is accounted for in the same manner as described above. This is because paragraph 10 of IFRS 15 specifies that a contract can be written, oral, or implied by a reporting entity's customary business practices.

Retailer Y

Similar to Entity X, Retailer Y should recognise revenue by including 90% (that is, excluding 10% of expected returns) of its sales in the transaction price, recognise a refund liability for the amount of consideration that the entity does not expect to be entitled to (that is, 10%), because it will be refunded to customers, and recognise a corresponding right to return asset.

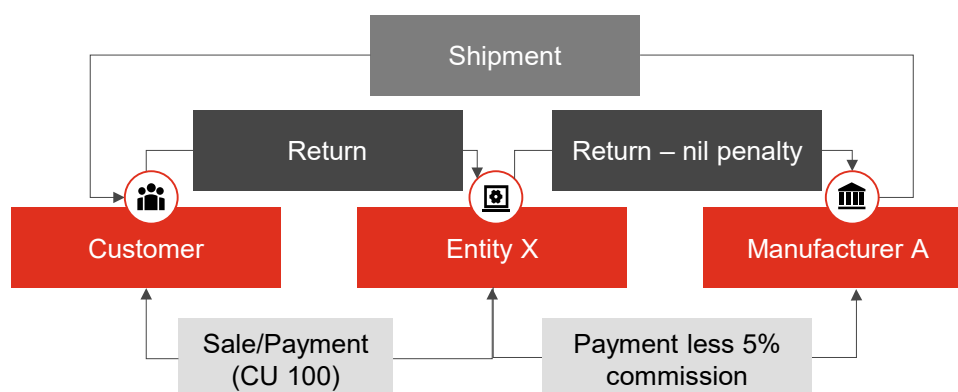
Some retailers only offer returns in the form of an exchange. Paragraph B26 of IFRS 15 notes that exchanges by customers of one product for another of the same type, quality, condition and price are not considered returns for the purposes of recognising revenue.

1.5 Sales of goods – Agent versus principal

Background

Entity X operates a website that sells goods produced by a number of manufacturers. Entity X enters into a contract with Manufacturer A to sell Manufacturer A's products online. Entity X's website facilitates payments between Manufacturer A and the end-consumer. The sales price is established by Manufacturer A, and Entity X earns a commission equal to 5% of the sales price.

Manufacturer A ships the goods directly to the customer and insures for loss/damage during shipment. Legal title is transferred from Manufacturer A to Entity X when the goods leave Manufacturer A's warehouse. The end-consumer returns the goods to Entity X if they are dissatisfied. Entity X has the right to return goods to Manufacturer A without penalty if they are returned by the customer.



Issue

Is Entity X the principal or agent for the sale of goods to the end-customer?

Solution

The specified good or service in this arrangement is the good which is produced by Manufacturer A. Entity X has considered the following facts when assessing whether it is acting as agent or principal (that is, whether it takes control over the specific good before it is transferred to the customer) [IFRS 15 paras B35-B37]:

- Entity X only takes legal title once the end-customer has committed to and paid for the goods.
- Entity X does not have the ability to benefit from the goods in other ways, such as redirecting the asset to another customer sale, given that Manufacturer A ships the goods directly to the customer.
- Entity X is reimbursed by Manufacturer A in the rare case of a dissatisfied customer.
- The sales price is established by Manufacturer A. Therefore, Entity X has no discretion in establishing the price for the goods.

Entity X also considered indicators that it is acting as principal, including the fact that Entity X takes legal title and that dissatisfied customers return the goods directly to Entity X. However, legal title is only retained by Entity X during a short period of time before the goods are transferred to the customer, and so Entity X does not control the goods. Entity X has no inventory risk before the goods have been transferred to the end-customer, and no inventory risk after transfer of control to the customer, given that Entity X has a right to return goods to Manufacturer A without penalty. Hence, Entity X is acting as the agent.

On this basis, Entity X should recognise commission revenue, on a net basis, when it has satisfied the promise to facilitate the sale (that is, when the goods are purchased by a customer).

Manufacturer A should recognise revenue of CU100 and, simultaneously, a commission charge of CU5.

1.6 Bill-and-hold arrangements

Background

Entity X, a video game company, enters into a contract during 20X6 to supply 100,000 video game consoles to Retailer Y. The contract contains specific instructions from the retailer about where the consoles should be delivered. Entity X should deliver the consoles in 20X7 at a date to be specified by the retailer. Retailer Y expects to have sufficient shelf space at the time of delivery.

As at 31 December 20X6, Entity X has inventory of 120,000 game consoles, including the 100,000 relating to the contract with Retailer Y. The 100,000 consoles are stored with the other 20,000 game consoles, which are all interchangeable products; however, Entity X will not deplete its inventory below 100,000 units.

Issue

When should Entity X recognise revenue for the 100,000 units to be delivered to Retailer Y?

Solution

Bill-and-hold arrangements arise where a customer is billed for goods that are ready for delivery, but the entity does not ship the goods to the customer until a later date. Entities must assess in these cases whether control has transferred to the customer, even though the customer does not have physical possession of the goods. Revenue is recognised when control of the goods transfers to the customer.

Paragraph B81 of IFRS 15 presents the following additional criteria that all need to be met in order for the customer to have obtained control in a bill-and-hold arrangement:

- The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);
- The product must be identified separately as belonging to the customer;
- The product currently must be ready for physical transfer to the customer; and
- The entity cannot have the ability to use the product or to direct it to another customer.

Entity X should not recognise revenue until the bill-and-hold criteria are met, or until Entity X no longer has physical possession and all of the other criteria related to the transfer of control have been met. Although the reason for entering into a bill-and-hold transaction is substantive (such as lack of shelf space), the other criteria are not met, because the game consoles produced for Retailer Y are not separated from other products.

1.7 Purchases made in instalments ('layaways')

Background

Retailer Y entered into an agreement with a customer whereby Retailer Y sets aside specific merchandise valued at CU500 and collects a cash deposit of CU50 from the customer on the day that the contract is entered into.

The merchandise will only be released to the customer once the purchase price is paid in full. The customer has three months to finalise the purchase. There is no fixed payment commitment; that is, the customer can pay in several instalments over that three-month period. The cash deposit and any subsequent payments are forfeited if the customer fails to pay the entire purchase price by the end of the three-month period.

Retailer Y can use the merchandise to satisfy other customer orders and replace them with similar goods during the layaway period. Retailer Y must refund the cash paid by the customer for merchandise that is lost, damaged or destroyed before the merchandise transfers to the customer.

Issue

When should Retailer Y recognise revenue?

Solution

Layaway sales (sometimes referred to as 'lay-buys' or 'will call') involve the seller setting aside merchandise and collecting a cash deposit from the customer. The seller might specify a time period within which the customer is required to finalise the purchase, but there is often no fixed payment commitment. The merchandise is typically released to the customer once the purchase price is paid in full. The cash deposit and any subsequent payments are forfeited if the customer fails to pay the entire purchase price. The seller is required to refund the cash paid by the customer for merchandise that is lost, damaged or destroyed before control of the merchandise transfers to the customer.

Retailer Y will first need to determine whether a contract exists in a layaway arrangement. It is likely that a contract does not exist at the outset of a typical layaway arrangement, because the customer has not committed to perform its obligation (that is, payment of the full purchase price). Retailer Y should not recognise revenue for these arrangements until the contract criteria are met [IFRS 15 para 9] or the entity has no remaining obligations and all, or substantially all, of the consideration promised has been received or the contract has been terminated [IFRS 15 para 15].

Some layaway sales could be, in substance, a credit sale if management concludes that the customer is committed to the purchase and a contract exists. Management will need to determine in those circumstances when control of the goods transfers to the customer. An entity that can use the selected goods to satisfy other customer orders, and replace them with similar goods during the layaway period, is likely to have retained control of those goods. Management should consider the bill-and-hold criteria discussed in paragraph B81 of IFRS 15 to determine when control of the goods has transferred (see FAQ 1.5 for more guidance on bill-and-hold sales).

1.8 Consignment arrangements

Background

Entity X sells teak furniture to Retailer Y, who operates a garden centre, on a consignment basis. The products are immediately offered for sale in Retailer Y's garden centre. Entity X retains legal title to the products until they are sold to the end-customer. Retailer Y does not have an obligation to pay Entity X until a sale occurs, and any unsold products can be returned to Entity X. Entity X also retains the right to take back any unsold products, or to transfer unsold products to another retailer. Once Retailer Y sells the products to the end-customer, Entity X has no further obligations, and Retailer Y has no further return rights.

Issue

When does Entity X recognise revenue?

Solution

Entity X should only recognise revenue when Retailer Y sells the product to the end-customer.

Although Retailer Y has physical possession of the products, it does not have control of the products when the goods are delivered by Entity X. Retailer Y only has the right to sell the products and does not have an unconditional obligation to pay Entity X until a sale to the end-customer occurs. Entity X also retains the right to call back any products that have not been sold by Retailer Y. This therefore indicates that this arrangement is a consignment arrangement in terms of paragraph B78 of IFRS 15. As a result, revenue is not recognised by Entity X when the goods are delivered to Retailer Y, in accordance with the guidance in paragraphs B77 and B78 of IFRS 15.

Entity X should also assess who is their customer – Retailer Y or the end-consumer. If its customer is the end-customer (that is, Retailer Y is acting as an agent), Entity X would recognise revenue in the amount that was received from the end-customer, and the amount retained by Retailer Y would be recognised as a commission expense by Entity X. If Retailer Y is the customer, Entity X would recognise revenue in the amount that was received from Retailer Y.

1.9 Sale of gift cards

Background

Entity X sells gift cards. The gift cards are valid for up to one year from the date of purchase and can only be redeemed at Entity X outlets; furthermore, the customer cannot obtain a cash reimbursement for unspent amounts or unused cards.

Entity X expects 10% of the gift card's value to expire unused, based on historical information. Unspent amounts after a year are kept by Entity X and forfeited by the customer. Entity X has no obligation to remit unused gift card amounts to end-customers or to a third party (for example, government).

On 31 August 20X1, 60 customers purchased CU100 gift cards from Entity X. At 31 December 20X1, 36 of those 60 customers fully redeemed their gift cards for Entity X products for a total of CU3,600.

Issue

Should Entity X recognise revenue on the sale of gift cards or on their redemption?

Solution

Entity X should recognise revenue on redemption of gift cards. The customer's non-refundable prepayment to an entity gives them a right to receive a good or service in the future. Entity X should recognise a contract liability (and not revenue) for any consideration received that is attributable to a customer's unexercised rights. However, customers might not exercise all of their contractual rights, which are often referred to as 'breakage'. [IFRS 15 App B para B45]

Entity X expects to be entitled to a breakage amount and recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customers [IFRS 15 App B paras B46–B47]. Entity X has assessed that it has adequate historical information to estimate breakage revenue in proportion to the historical pattern of rights exercised by the customer. In making this assessment, it has determined that recognising 10% breakage would result in recognition of only that amount of revenue that is not highly probable of a significant reversal.

At the time of gift card purchase, Entity X should make the following entries:

Dr. – Cash (B/S) CU6,000

Cr. – Contract Liability – Gift Card (B/S) CU6,000

The total breakage estimate is CU600 for CU6,000 of gift cards. The expected value to be redeemed by customers is CU5,400. For the period up to 31 December 20X1, Entity X should recognise the purchases made of CU3,600 in the following manner:

Dr. – Contract liability CU4,000

Cr. – Revenue CU3,600 (reflecting the product's selling price)

Cr. – Breakage revenue CU400 ($CU3,600 / CU5,400 * CU600$)

The breakage revenue is calculated as follows: Value of gift cards redeemed/Total gift card value × total estimated breakage revenue. Breakage estimates would usually be updated at each period-end, and adjustments would be made where necessary.

Calculating breakage might be more complex for entities who sell gift cards regularly and with longer or no expiry date. IFRS 15 permits an entity to use a portfolio approach for practical application if the entity reasonably expects that the effects on the financial statements would not differ materially from applying IFRS 15 to the individual contracts.

Advance payments for gift cards are generally not considered to result in the transaction having a significant financing component, because the timing of redeeming the gift card is at the discretion of the customer. [IFRS 15 para 62(a)]

1.10 Extended warranties

Background

Retailer X sells electrical goods that come with a manufacturer's one-year warranty against manufacturing defects. 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 at the same date of sale as the electrical good.

The sales price of the product is CU500, and the extended warranty costs CU120.

This contract is excluded from the scope of IFRS 17, because it relates to 'warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer'. [IFRS 17 para 7a]

Issue

How should Retailer X account for this arrangement?

Solution

This arrangement with the customer includes the following goods or services: (1) electrical goods; and (2) an extended warranty.

A warranty that a customer can purchase separately from the related good or service (that is, it is priced or negotiated separately) is a separate performance obligation. The fact that it is sold separately indicates that a service is being provided beyond ensuring that the product will function as intended. Warranties that cannot be purchased separately should be assessed to determine whether the warranty provides a service that should be accounted for as a separate performance obligation. Warranties that provide assurance that a product will function as expected and in accordance with certain specifications are not separate performance obligations.

Retailer X should account for the product warranty (against manufacturing defect) in accordance with IAS 37 and recognise an expense and liability for expected extended warranty obligation. Retailer X should account for the extended warranty as a separate performance obligation, with revenue recognised as that obligation is satisfied over the three-year period.

A return in exchange for cash or credit should generally be accounted for as a right of return. If customers have the option to return a defective good for cash, credit, or a replacement product, management should estimate the expected returns in exchange for cash or credit as part of its accounting for estimated returns.

2

Customer incentives and
other similar transactions

2.1 Volume discounts

Background

Example 1

Entity X sells 1,000 products to Retailer Y for CU10,000. In addition, Retailer Y will receive a 5% discount on all purchases if Retailer Y purchases more than 7,500 products (CU75,000 excluding the discount). Entity X forecasts that, due to the historic seasonality of the revenue (which peaks in summer time), the annual sales will be CU100,000.

Example 2

Entity X sells 1,000 products to Retailer Z for CU10,000. In addition, Retailer Z will receive a 5% discount on any purchases over and above 7,500 products (CU75,000 excluding the discount). Entity X forecasts that, due to the historic seasonality of the revenue (which peaks in summer time), the annual sales will be CU100,000.

Issue

How should Entity X account for the volume discount arrangements?

Solution

Example 1 – Retailer Y

The transaction price includes an element of consideration which is variable or contingent on future events. IFRS 15 requires an entity to estimate an amount of variable consideration by using either the 'expected value' or the 'most likely amount', whichever method is a better prediction of the final outcome. The transaction price includes variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

The transaction price for the 1,000 products is CU9,500, reflecting an expected reimbursement of CU500. Entity X will recognise a separate refund liability for the difference between the invoice price and the transaction price, because this represents the cash that it expects to refund to Retailer Y. Entity X will update its estimate of expected reimbursement at each reporting date until the uncertainty is resolved.

Example 2 – Retailer Z

Entity X should account for the prospective volume discount as a separate performance obligation in the form of a material right (option to purchase additional products at a discount) and allocate the transaction price to the goods and the option based on their relative stand-alone selling prices.

Entity X would theoretically need to assess the stand-alone selling price of each option. However, because the future goods are similar to the original goods, paragraph B43 of IFRS 15 permits an entity to include the optional goods or services that it expects to provide (and corresponding expected customer consideration) for the purposes of allocating the transaction price.

Assuming that Entity X elects to apply the practical alternative in paragraph B43 of IFRS 15, it would calculate the expected consideration for those additional goods as CU97,500, reflecting the 5% discount on the expected purchase of CU25,000 over and above CU75,000, and it would recognise CU9.75 for each product (that is, CU97,500 total expected consideration divided by 10,000 total products).

Entity X would therefore recognise revenue of CU9,750 for the initial sale of 1,000 products, with a contract liability of CU250 for the material right not yet satisfied. The CU250 represents the CU10 price paid by the customer in excess of the CU9.75 transaction price allocated to each product. The contract liability would accumulate until the discounted products are delivered, at which time it would be recognised as revenue when the products are delivered.

Entity X would update its estimate of the total sales volume at each reporting date, with a corresponding adjustment to cumulative revenue and the value of the separate contract liability.

2.2 Co-advertising arrangements

Background

Entity X has entered into agreements with two of its customers (Retailer Y and Retailer Z) for the sale of products totalling CU100m. Each arrangement also includes obligations for the customer with respect to product advertising and promotion, as described below.

Retailer Y

The arrangement with Retailer Y requires Retailer Y to publish advertisements of Entity X's products in a local newspaper. Entity X has entered into similar arrangements in the past, directly with the local newspaper. If Entity X had not entered into this arrangement with Retailer Y, Entity X would advertise locally.

Retailer Y will contract with the local newspaper directly and pay for the full cost of the campaign. Entity X has committed to reimburse Retailer Y for 50% of the advertising costs. In order for Entity X to reimburse Retailer Y, it requires Retailer Y to place the adverts and to provide the associated proof of placement in the local newspaper.

Entity X is paying Retailer Y fair value, which can be reasonably estimated, for such services.

Retailer Z

The arrangement with Retailer Z entitles Retailer Z to an advertising allowance of CU10m from Entity X. The arrangement requires Retailer Z to advertise Entity X's goods on advertising boards and in its publicity mailings with certain regularity throughout the year. Retailer Z only advertises brands that it sells.

Issue

How should Entity X account for these transactions?

Solution

Arrangement with Retailer Y

The payment made by Entity X to Retailer Y is for a distinct service, as described by paragraph 27 of IFRS 15. Entity X has previously purchased similar advertising services at similar pricing, and the service is being provided by a third party. Entity X could have also entered into this arrangement regardless of whether Retailer Y is a customer. Entity X is paying Retailer Y fair value, which can be reasonably estimated, for such services. Entity X therefore recognises the advertising costs as an expense in the income statement.

If the consideration that Entity X paid to Retailer Y for distinct advertising services had been in excess of the fair value of the service received, the excess consideration is recognised as a reduction in the transaction price for the products sold, because the excess amount represents, in substance, a discount to Retailer Y.

It can be difficult to determine the fair value of the distinct goods or services received in some situations. If an entity is not able to determine the fair value of the goods or services received, it should account for all of the consideration paid or payable to the retailer as a reduction of the transaction price, because it is unable to determine the portion of the payment that is a discount provided to the retailer.

Arrangement with Retailer Z

Entity X is unable to identify a distinct service and/or separate the arrangement from the sale of the products to Retailer Z. Therefore, the amounts due by Entity X to Retailer Z would be recognised as a reduction of Entity X's revenue.

In practice, it is often challenging to identify co-advertising as a distinct service. Such arrangements are usually negotiated as part of the price of the products sold. Advertising activities might or might not be specifically agreed, and they often include 'in store' or localised advertising that can only be delivered by the retailer in connection with selling the products. These factors, therefore, often make it difficult to conclude that the services are distinct.

2.3 Slotting fees and other fee paid to retailers

Background

It is common practice, and often contractually agreed, that consumer products entities pay various fees in connection with product sale arrangements. The fees come in many different forms, but they are generally designed to encourage the sales of an entity's products to end-customers by enabling the retailer to sell at a lower price, to reduce the retailer's cost of selling, or to increase advertising.

Some of the fees paid by consumer products entities to retailers include:

- Slotting fees – paid for a product to be allocated to advantageous spaces in the retailer's premises for a defined period of time. For example, the products are placed near the checkout counter, to be more noticeable by customers;
- Pallet fee – a retailer buys a pallet of goods and places the pallet directly on its store floor for display and sale of the products. The consumer products entity gives a discount to the retailer justified by expectations of increased sales volumes and reduced packaging and handling costs; and
- Retail fixture compensation – a consumer products entity pays a retailer compensation to cover their cost of their retail store renovation to meet the standard required by the consumer products entity. This can be paid as a lump sum or a discount offered on future sales.

The accounting considerations for all of these fees and rebates are similar, and they are captured in the following example:

Entity X sells energy drinks to Retailer Y for CU10,000. Simultaneously, Entity X is invoiced CU500 by Retailer Y as a fee to ensure that its products receive prominent placement on store shelves (that is, a slotting fee), which will generate additional sales. The fee is negotiated as part of the contract for sale of the energy drinks.

Issue

How should Entity X and Retailer Y account for this arrangement?

Solution

Entity X

Entity X does not receive a good or service that is distinct in exchange for the payment to Entity Y. Entity X should recognise the slotting fees paid to Retailer Y as a reduction of the revenue recognised from the sale of goods to Retailer Y.

Similar to slotting fees, other fees such as pallet fees and retail fixed compensation that are linked to the sale of the product and contribute to a retailer's selling process are not a distinct service, and so they should be recognised as a reduction of revenue. Paragraph 27 of IFRS 15 provides guidance on determining when a good or service is distinct. Determining whether a payment is for a distinct good or service received from a customer requires judgement. An entity might be paying a customer for a distinct good or service if the entity is purchasing something from the customer that is normally sold by that customer.

Retailer Y

Retailer Y should recognise the amounts received as a reduction in the cost of inventory acquired under this contract.

2.4 Price protection

Background

Manufacturer B enters into a contract to sell goods to Retailer C for CU1,000. Manufacturer B also offers price protection, whereby it will reimburse the retailer for any difference between the sale price and the lowest price offered to any customer by Manufacturer B during the six months following sale of the goods to Retailer C. This clause is consistent with other price protection clauses offered in the past, and Manufacturer B believes that it has experience that is predictive for this contract.

Manufacturer B expects that it will offer a price decrease of 5% during the price protection period, and it concludes that it is highly probable that a significant reversal of cumulative revenue will not occur if estimates change.

Issue

How should Manufacturer B determine the transaction price?

Solution

The transaction price includes an element of consideration which is variable or contingent on future events. IFRS 15 requires an entity to estimate an amount of variable consideration by using either the 'expected value' or the 'most likely amount', whichever method is a better prediction of the final outcome. The transaction price includes variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. [IFRS 15 paras 50–58]

The transaction price is CU950, because the expected reimbursement is CU50. The expected payment to Retailer C is reflected in the transaction price at contract inception, because that is the amount of consideration to which the manufacturer expects to be entitled after the price protection. Manufacturer B will recognise a liability for the difference between the invoice price and the transaction price, since this represents the cash that it expects to refund to the retailer. Manufacturer B will update its estimate of expected reimbursement at each reporting date until the uncertainty is resolved.

If an entity has no past practice or expectation of offering price protection, it accrues the rebate as a reduction of revenue for any goods already sold as soon as it has offered the payment, based on the amount of inventory in the channel, as required by paragraph 72 of IFRS 15.

It is also common for retailers to have a price protection policy in place to reimburse its customers for the difference between the purchase price and the lower price offered by direct competitors. The arrangement with the customer is often offered for a limited period following the sale. A retailer should follow the same accounting as described above, recognising a liability of the expected reimbursement, applying the guidance in IFRS 15 for variable consideration.

2.5 Customer incentives – Discount coupons

Background

Retailer X has launched a promotional campaign offering discount coupons to any customers that purchase goods with a total value exceeding CU1,500. The discount coupons entitle the customer to a 50% discount on the purchase of selected items during the 90 days immediately following the campaign.

Retailer X has issued 60 of the 50% coupons to high-spending consumers who had purchased goods totalling CU100,000 during the campaign. Based on historical trends, Retailer X expects that:

1. 75% of the consumers receiving 50% discount coupons will use the coupon; and
2. customers using the coupons will spend on average CU1,000.

Retailer X has concluded that it will still make a positive margin on the transactions when the coupons are used. Therefore, Retailer X does not have an onerous contract to recognise in accordance with IAS 37.

Issue

How should Retailer X account for the discount coupon issued to customers?

Solution

Customer options to acquire additional goods or services include sales incentives, customer loyalty points, contract renewal options, and other discounts. If the option provides a customer with a material right, the customer is purchasing two things in the arrangement – the good or service originally purchased, and the right to a free or discounted good or service in the future – and is effectively paying in advance for future goods or services. [IFRS 15 App B para B40]

Retailer X has sold goods for a total amount of CU100,000 and it has simultaneously granted to its customers 50% off coupons that will be used in future purchases by an estimated 75% of customers. The discount coupons represent a material right, and so they are accounted for as separate performance obligations in the arrangement.

Retailer X has decided to use the portfolio approach, on the basis that it reasonably expects that the effects on the financial statements would not differ materially from applying IFRS 15 to the individual contracts.

In accordance with paragraph 74 of IFRS 15, the allocation of transaction price to performance obligations will be undertaken on a relative stand-alone selling price basis. The estimated stand-alone selling price of the material right should reflect the discount that the customer would be entitled to, adjusted for any discount that the customer could receive without exercising the option (that is, any discount available to any other customer) and the likelihood that the option will be exercised.

Determination of the stand-alone selling price of the options as a portfolio:

50% discount coupons = net price of additional products × discount × likelihood

$$\text{CU1,000} \times 60 \times 50\% \times 75\% = \text{CU15,000}$$

Allocation of the transaction price:

Total value of the transactions = price of initial purchase + option value granted

$$\text{CU100,000} + \text{CU15,000} = \text{CU115,000}$$

The transaction price is allocated to the material right, based on the relative stand-alone selling price:

$$\text{Transaction price} = \text{CU100,000}$$

Transaction price allocated to the discount coupons

$$\text{CU15,000} / \text{CU115,000} \times \text{CU100,000} = \text{CU13,040}$$

Accounting entries on initial purchase:

Dr. Cash (B/S) CU100,000

Cr. Product sales (P/L) CU86,960

Cr. Contract liability – discount coupons (B/S) CU13,040

Accounting entries on redemption of coupons:

Dr. Cash (B/S) (50% of CU1,000 × 45) CU22,500

Dr. Contract liability – discount coupons (B/S) CU13,040

Cr. Products sales (P/L) CU35,540

An entity should consider the guidance on constraining variable consideration to determine whether or not it expects to be entitled to a breakage amount with regard to redemption of the coupons. If the entity expects to be entitled to a breakage amount, it recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer (that is, as coupons are redeemed). If the entity does not expect to be entitled to a breakage amount, it recognises the expected breakage amount as revenue when the likelihood of the customer exercising its rights becomes remote. The assessment of estimated breakage should be updated at each reporting period. Changes in estimated breakage should be accounted for by adjusting the contract liability to reflect the remaining coupons expected to be redeemed.

Estimating breakage and updating these estimates could be complex, particularly for coupons, which might extend for significant periods of time, or never expire. The accounting for these items will often require a significant amount of data tracking in order to update estimates each reporting period. Management should not adjust the stand-alone selling price originally allocated to a customer option when updating its estimate of breakage (for example, when updating the number of coupons that it expects customers to redeem).

2.6 Customer incentives – Discounts offered without purchase

Background

Retailer X, a clothing retailer, has launched a promotional campaign whereby a coupon is published in a national newspaper giving a discount of 5% off any purchase over CU50 in any of Retailer X's stores. Retailer X's margin on similar transactions, prior to the impact of the coupons, is between 30% and 40%. Therefore, Retailer X has determined that there is no onerous contract to be recognised in accordance with IAS 37.

Issue

How does Retailer X account for these coupons?

Solution

The issuance of the coupons does not create a binding contract with a customer. This only occurs once the customer makes the purchase exceeding CU50. Retailer X should not recognise a liability in its financial statements for the distribution of coupons. Retailer X should account for discount coupons as an adjustment to the transaction price only when the customers redeem them.

2.7 Customer loyalty programme

2.7.1 Loyalty points are redeemed by the retailer

Background

- Retailer X operates retail stores and a website where customers can buy dresses.
- Retailer X has a customer loyalty programme in place that awards customers 1 point for every CU1 spent on buying dresses.
- Points are only redeemable for a CU0.10 discount on future purchases (that is, the discount per loyalty point earned) and cannot be redeemed for cash.
- Retailer X expects 5% of points to expire unredeemed, based on historical trends.
- Retailer X has sold dresses for CU1,000 during the period and customers have therefore earned a total of 1,000 loyalty points during the period.

Issue

How should Retailer Y account for the loyalty points issued to its customers?

Solution

The transaction involves Retailer X committing to two performance obligations:

1. The goods purchased; and
2. The rights related to the loyalty points, because Retailer X has effectively provided the customer with an option (that is, a material right that it would not receive without entering into that contract) to purchase additional goods in the future in terms of paragraphs 26 and B40 of IFRS 15.

Retailer X has decided to use the portfolio approach, on the basis that it reasonably expects that the effects on the financial statements would not differ materially from applying IFRS 15 to the individual contracts.

In accordance with paragraph 74 of IFRS 15, the allocation of transaction price to performance obligations will be undertaken on a relative stand-alone selling price basis. The estimated stand-alone selling price of the material right should reflect the discount that the customer would be entitled to, adjusted for any discount that the customer could receive without exercising the option (that is, any discount available to any other customer) and the likelihood that the option will be exercised.

Determination of the stand-alone selling price of the option:

Total discount on future purchases = Discount × loyalty points awarded

CU0.10 × 1,000 points = CU100

Stand-alone selling price of the option granted = Total discount on future purchases – expected breakage of points

CU100 – (5% × 1,000 points × CU0.10) = CU95

Allocation of the transaction price:

Retailer Y has to allocate customer payments of CU1,000 between product sales and loyalty points, based on their relative stand-alone selling prices.

Total transaction value = Price of initial purchase + stand-alone selling price of the option granted

= (CU1,000 + CU95)

= CU1,095

Customer payment allocated to the loyalty programme = CU1,000 × CU95/CU1,095 = CU87

Customer payment allocated to the products sales = CU1,000 × CU1,000/CU1,095 = CU913

Accounting entries at initial purchase:

Dr. Cash (B/S) CU1,000

Cr. Products Sales (P/L) CU913

Cr. Contract Liability – Loyalty points (B/S) CU87

Retailer Y would recognise revenue of CU913 when the products are sold to the customer. It would defer revenue of CU87 and recognise it on redemption of the points by the customer or expiration.

An entity should consider the guidance on constraining variable consideration to determine whether or not it expects to be entitled to a breakage amount with regard to redemption of the loyalty points. If the entity expects to be entitled to a breakage amount, it recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer (that is, as loyalty points are redeemed). If the entity does not expect to be entitled to a breakage amount, it recognises the expected breakage amount as revenue when the likelihood of the customer exercising its rights becomes remote. The assessment of estimated breakage should be updated at each reporting period. Changes in estimated breakage should be accounted for by adjusting the contract liability to reflect the remaining loyalty points expected to be redeemed.

Estimating breakage and updating these estimates could be complex, particularly for customer loyalty programmes, which might extend for significant periods of time, or never expire. The accounting for these programmes will often require a significant amount of data tracking in order to update estimates each reporting period. Management should not adjust the stand-alone selling price originally allocated to a customer option when updating its estimate of breakage (for example, when updating the number of loyalty points that it expects customers to redeem).

2.7.2 Loyalty points are solely redeemable by another party

Background

Retailer Y participates in a customer loyalty programme in partnership with Airline B that awards 1 air travel point for each CU1 that a customer spends on goods purchased from Retailer Y. Programme members can only redeem the points for air travel with Airline B.

The transaction price allocated to each point, based on its relative estimated stand-alone selling price, is CU0.01. Retailer Y pays Airline B CU0.009 for each point redeemed.

Retailer Y sells goods totalling CU1 million and grants 1 million points during the period. Retailer Y allocates CU10,000 of the transaction price to the points, calculated as the number of points issued (1 million) multiplied by the allocated transaction price per point (CU0.01).

Retailer Y concludes that its performance obligation is to arrange for the loyalty points to be provided by Airline B to the customer, and that it is an agent in this transaction in accordance with the guidance in paragraphs B34–B38 of IFRS 15.

Issue

How should Retailer Y account for the loyalty points issued to its customers?

Solution

Retailer Y would measure its revenue as the commission that it retains for each point redeemed, because it has concluded that it is an agent for the loyalty point performance obligation. The commission is CU1,000, which is the difference between the transaction price allocated to the points (CU10,000) and the CU9,000 paid to Airline B. Retailer Y would recognise its commission when it transfers the points to the customer (on purchase of goods from Retailer Y), because Retailer Y has satisfied its promise to arrange for the loyalty points to be provided by Airline B to the customer.

2.7.3 Loyalty points are redeemable by multiple parties

Background

Retailer Z offers a customer loyalty programme in partnership with Hotel C whereby Retailer Z awards 1 customer loyalty point for each CU1 that a customer spends on goods purchased from Retailer Z.

Programme members can redeem the points for accommodation with Hotel C or as discounts on future purchases with Retailer Z.

The transaction price allocated to each point, based on its relative estimated stand-alone selling price, is CU0.01.

Retailer Z sells goods totalling CU1 million and grants 1 million points during the period. Retailer Z allocates CU10,000 of the transaction price to the points, calculated as the number of points issued (1 million) multiplied by the allocated transaction price per point (CU0.01). Retailer Z concludes that it has not satisfied its performance obligation, because it must stand ready to transfer goods or services if the customer elects not to redeem points with Hotel C.

Issue

How should Retailer Z account for the loyalty points issued to its customers?

Solution

Retailer Z should not recognise revenue for the CU10,000 allocated to the points when they are issued, because it has not satisfied its performance obligation; rather, the points balance will be held as a contract liability. Retailer Z should recognise revenue on redemption of the points by the customer with Retailer Z, or when the obligation is transferred to Hotel C, or when the points expire. Retailer Z will need to assess whether it is the principal or an agent in the arrangement if the customer elects to redeem the points with Hotel C.

3

Other revenue
transactions

3.1 Licensing brands

Background

Entity X is a well-known design house which designs, manufactures, distributes and sells luxury products branded with its famous trademark. Entity X grants a real estate developer a licence to use its brand name in connection with the sale of apartments for four years.

The real estate developer's intention is to construct and sell private luxury apartments using a 'stylistic concept' aligned to Entity X's brand. The real estate developer agrees to provide Entity X with an opportunity to influence the interior design, which is the primary responsibility of the real estate developer's design team. Entity X agrees to continue to promote the brand through national advertising campaigns.

Entity X receives a fixed fee of CU2 million, a royalty of 2% of the sales of the apartments, and a marketing fee of 1% of the sales of the apartments.

Issue

How should Entity X recognise the payments that it receives from the real estate developer as compensation for the use of its brand name?

Solution

The licence is a 'right to access the IP'. This is because the benefit for the real estate developer is dependent on the ongoing activities performed by Entity X that support or maintain the value of the brand. [IFRS 15 App B para B58]

Entity X needs to assess whether advertising represents a distinct performance obligation. In most cases, such activities are designed to support the brand rather than to provide a distinct service to the customer. Entity X has concluded that its obligation to continue to promote the brand through national advertising campaigns does not provide a distinct service to the real estate developer.

Entity X has also determined that the design oversight is not a separate performance obligation, but rather a protective right to ensure that the real estate developer uses the brand in a reasonable manner.

The total of the fixed amounts (CU2 million) is allocated to the licence, and it is recognised over time during the licence period.

Paragraph B63 of IFRS 15 provides an exception for the recognition of revenue of sales- or usage-based royalties promised in exchange for a licence of intellectual property. Revenue is recognised at the later of when the performance obligation is satisfied and when the sales or usages occur. Therefore, this royalty and marketing fee are recognised by Entity X when the apartments are sold, provided that this approach does not result in the acceleration of revenue ahead of the entity's performance.

3.2 Franchise agreement in multiple locations

Background

On 1 January 20X1, Entity Y grants a franchisee the exclusive right to operate a restaurant using Entity Y's brand in Country A for three years, and a licence to operate another branded restaurant in Country B for three years. However, because of an existing arrangement with another franchisee, the right in Country B does not begin until 1 January 20X2. The licence fee is equal to CU150,000 for each of the two licences.

Issue

How should Entity Y account for the licensing arrangements, in particular the contractual provisions that restrict the use of the brand for a period of three years and defer the starting period of the licence in Country B?

Solution

Restrictions of time, geographical region or use define the attributes of the promised licence, rather than whether the entity satisfies its performance obligation at a point in time or over time. Entity Y concludes that there are two separate performance obligations due to the different attributes in the licences (that is, different locations and time periods) [IFRS 15 App B para B62(a)]. The transaction price should be allocated between the two licences.

There is a reasonable expectation that Entity Y will undertake activities that will significantly affect the brand name to which the franchisee has rights, and the franchisee is directly exposed to any positive or negative effects of that brand and image throughout the franchise period. Therefore, the licences are rights to access intellectual property, and they are recognised over time [IFRS 15 App B para B58]. As noted above, the fact that the licences are for a period of three years is not considered in the assessment of whether the fee is recognised over time or at a point in time.

The licence fee allocated to the right to operate a restaurant in Country A is recognised from 1 January 20X1 on a straight-line basis over a period of three years. The licence fee allocated to the licence to operate the restaurant in Country B is recognised from 1 January 20X2 on a straight-line basis over a period of three years.

3.3 Franchise arrangement with product sales

Background

Entity X, a franchisor, grants a five-year franchise to an entity in exchange for an up-front payment of CU120,000, to accelerate Entity X's global expansion. Entity X specialises in clothing which is normally sold for CU100 per unit. As part of the franchise arrangement, Entity X agrees to sell this product to the franchisee for CU70 throughout the franchise period – a 30% discount on usual market prices to third parties. At this stage, no other services will be provided by the franchisor.

Issue

How does the Entity X account for the arrangement?

Solution

Entity X has transferred two performance obligations under the arrangement: a licence of the brand for five years, and a material right to acquire goods at a 30% discount to the market price. The transaction price of CU120,000 should be allocated by Entity X between the two performance obligations, based on the relative stand-alone selling prices.

Entity X calculates a stand-alone selling price of the franchise right of CU100,000. Entity X determines the stand-alone selling price of the material right based on the expected value of the discounts from planned purchases. Entity X expects that the customer will purchase 1,000 units at CU70, resulting in a material right equal to CU30,000.

The relative stand-alone selling price would be calculated as follows:

- Licence = CU92,308 ($CU120,000 * CU100,000 / CU130,000$)
- Material right = CU27,692 ($CU30,000 * CU100,000 / CU130,000$)

There is a reasonable expectation that the franchisor will undertake activities that will significantly affect the brand name to which the franchisee has rights, and the franchisee is directly exposed to any positive or negative effects of that brand and image throughout the franchise period. Therefore, the revenue from the franchise rights is recognised over the duration of the franchise arrangement, and the right to discounted products is recognised as the units are sold.

3.4 Franchise arrangement with non-refundable up-front fee

Background

Entity X is a franchisor for restaurants that are operated by franchisees. Entity X requires a franchisee to pay a non-refundable up-front fee of CU200,000 on the signing of the contract.

The franchisee obtains the right to operate a restaurant using the Entity X brand name, concept and menus for a period of two years, during which time Entity X must maintain the brand through endorsements and regional advertising.

In addition, Entity X provides branded front-of-house fixtures, cooking equipment and cash registers, valued at CU50,000 (that is, the stand-alone selling price of these goods).

Issue

How should Entity X recognise revenue for this arrangement?

Solution

Entity X determines that it has two performance obligations: (1) a promise to grant a licence; and (2) a promise to transfer fixtures and equipment.

There is a reasonable expectation that Entity X will undertake activities that will significantly affect the brand name to which the franchisee has rights, and the franchisee is directly exposed to any positive or negative effects of that brand and image throughout the franchise period [IFRS 15 App B para B58]. Therefore, Entity X recognises the revenue from the franchise rights on a straight-line basis over the duration of the franchise arrangement, and the revenue from the fixtures and equipment as control is transferred.

At the signing of the contract, there is no transfer of goods or services to the customer; therefore, no revenue is recognised, even if the up-front fee is non-refundable. Entity X should not recognise revenue on receipt of an up-front fee, even if it is non-refundable, because the fee does not relate to the satisfaction of a performance obligation. The non-refundable fee is an advance payment for future goods or services, and it should be included in the transaction price and allocated to the separate performance obligations identified in the contract [IFRS 15 App B para B51].

Assuming that CU50,000 represents the stand-alone selling price of the fixtures and equipment, and CU150,000 represents the stand-alone selling price of the licence, Entity X would recognise CU50,000 on transfer of the fixtures and equipment, and CU150,000 for the licence over the two years.

3.5 Telecommunications sales by retailers

Background

Telecommunications providers often sign up new prepaid customers through third party distributors such as retailers in order to benefit from the retail store footprint of the retailer. The customer of the retailer is the end-user of the telecommunication products.

In this example, Retailer Y earns a nominal fee from selling the SIM card and continuing commission from the end-customers' continued use of the SIM card. Retailer Y sells SIM cards to its customers in its store, and it recognises revenue for the sale when control of the SIM card transfers to the customer.

Retailer Y earns a fee when the end-customer activates the SIM card, as well as when the end-customer loads additional airtime or data onto the card. End-customers load airtime through any channel in the form of physical vouchers, virtual top-ups, mobile top-ups, banking applications, etc. These SIM cards are included on Retailer Y's base of activated cards.

Retailer Y is not itself a telecommunications provider, and so it acts as agent by providing a distribution channel. At the point of sale of the SIM card, Retailer Y has fulfilled its performance obligation to its customer, because it is an agent in the arrangement for the provision of telecommunications services.

Issue

How does Retailer Y account for ongoing commission?

Solution

IFRS 15 requires an entity to estimate an amount of variable consideration by using either the 'expected value' or the 'most likely amount', whichever method is a better prediction of the final outcome. The transaction price includes variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

The commissions earned by Retailer Y on prepaid contracts are variable in nature, because the entitlement to these amounts is dependent on the future spending patterns of the prepaid customers, and therefore contingent on a future event occurring or not occurring. Therefore, Retailer Y should estimate the amount of variable consideration to which it will be entitled for the contracts that it has entered into with its customers.

It is likely that the 'expected value' method would be the most appropriate method to estimate variable consideration. This is because the future customer spend, and therefore the ongoing commission earned by Retailer Y, could be any one of a large range of possible outcomes, and there is a large portfolio of customers. This includes consideration given to all of the information available to an entity, which might include information gathered on other similar contracts.

Retailer Y should apply the revenue constraint, which is based on an entity only recognising variable consideration to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Considerations to take into account in assessing the extent of the constraint include: whether the revenue is highly susceptible to factors outside Retailer Y's influence; the period over which the uncertainty will be resolved; and whether Retailer Y's experience is limited or has limited predictive value.

3.6 Concession outlets

Background

Entity A operates a large department store that contains concession outlets. Entity A provides the concessionaire with serviced space in the store, sales staff, point of sale equipment and stock-room space. Entity A also administers the sales of the products, including collecting cash from the end-customers.

The concessionaire pays a fixed contractual fee to Entity A of CU10,000 per annum plus 20% of the outlet's total product sales. The concessionaire determines the products sold and the prices charged to customers, and it 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 products.

Entity A has the right to change the location of the space allocated to the concessionaire at any time, and so the arrangement is not considered a lease.

Issue

How does Entity A account for this arrangement?

Solution

The specified good or service in this arrangement is the products sold in the concession outlet. Entity A does not, at any point, have control of the products which are sold. Although Entity A transacts with the end-customer, it does not set prices or take inventory risk [IFRS 15 App B paras B36–B37]. Therefore, Entity A is acting as an agent in selling to the end-customer and is receiving a 'commission' in consideration for the service that it is performing for the concessionaire.

Entity A recognises the 'commission' receivable from the concessionaire as revenue, rather than the gross revenue from the sale of the concessionaire's goods.

3.7 Excise duties and taxes

Background

Example A

Entity A is a global producer and distributor of branded alcoholic spirits. Entity A pays an excise duty based on the value, as well as the volume, of products that leave a bonded warehouse. The movement of products from the bonded warehouse for customs clearance is the triggering event of the obligation to pay excise duty. In the event that a customer fails to make payment, or if products are not sold, Entity A cannot claim a refund of the excise duty that it has paid. Entity A collects from its customers the gross revenue and duty amounts.

Entity A has no legal or constructive obligation to reflect any change of the rate of excise duty in the selling price of products. An increase in the rate of excise duty can lead the entity to increase its selling price, but such increases are a commercial decision and would not be automatic. The tax is not separately presented on the invoice.

Example B

Entity B sells widgets to customers in various jurisdictions. In a particular jurisdiction, the manufacturer pays a sales tax calculated based on the number of widgets sold. The triggering event of the obligation is each individual sale to a customer. The tax is separately identified on the invoice to the customer, and any increase in the tax rate would result in an equivalent increase of the tax charged to the customer. The manufacturer receives a refund of the tax if the receivables are not collected.

Issue

How should Entity A and Entity B recognise the taxes that they collect from their customers gross (that is, as revenue and expense) or net of the amount remitted to a third party (such as governmental agencies)?

Solution

Entities often collect amounts from customers that are required to be remitted to a third party (for example, collecting and remitting taxes to a governmental agency). Taxes collected from customers could include sales, use, value-added and some excise taxes. Amounts collected on behalf of third parties, such as certain sales taxes, are not included in the transaction price, because they are collected from the customer on behalf of the government. The entity is the agent for the government in these situations.

Taxes that are based on production, rather than sales, are typically imposed on the seller and not on the customer. An entity that is obligated to pay taxes based on its production is the principal for those taxes, and so it recognises the tax as an operating expense, with no effect on revenue.

Management needs to assess each type of tax, on a jurisdiction-by-jurisdiction basis, to conclude whether to net these amounts against revenue or to recognise them as an operating expense. The intention of the tax, as written into the tax legislation in the particular jurisdiction, should also be considered.

The name of the tax (for example, sales tax or excise tax) is not always determinative when assessing whether the entity is the principal or the agent for the tax. Whether or not the customer knows the amount of tax also does not necessarily impact the analysis. Management needs to look to the underlying characteristics of the tax and the tax laws in the relevant jurisdiction to determine whether the entity is primarily obligated to pay the tax or whether the tax is levied on the customer. This could be a significant undertaking for some entities, particularly those that operate in numerous jurisdictions with different tax regimes.

Indicators that taxes are the responsibility of the entity, and therefore should be recorded as an expense (as opposed to a reduction of transaction price), include but are not limited to the following:

- The triggering event to pay the tax is the production or the importation of goods. Conversely, where the triggering event is the sale to a customer, this might indicate that the entity is collecting the tax on behalf of a governmental entity.
- The tax is based on the number of units or on the physical quantity (for example, number of cigarettes or volume of alcoholic content) produced by the entity, rather than the selling price to customers.
- The tax is due on accumulated earnings during a period of time, as opposed to each individual sale transaction.
- The entity cannot claim a refund of the tax in the event that the related inventory is not sold or the customer fails to pay for the goods or services being sold.

- The entity has no legal or constructive obligation to change prices in order to reflect taxes. Conversely, where the tax is clearly separate from the selling price, and a change in the tax would result in an equivalent change in the amount passed through to the customer, this might indicate that the entity is collecting the tax on behalf of the government.

The above indicators should be considered along with the intended purpose of the tax, as written into the tax legislation in the particular jurisdiction. The existence (or non-existence) of one of the above indicators might not be determinative on its own.

Example A: Entity A is the principal for the excise duty, because the triggering event is the movement of products (as opposed to sales to customers), Entity A makes a decision whether to adjust the selling price of products to pass the tax on to the customer, and it cannot claim a refund in the event of a customer's failure to pay. Entity A should therefore recognise the excise duty as an expense, as opposed to a reduction of transaction price.

Example B: Entity B is likely collecting the sales tax as an agent on behalf of a governmental agency. The triggering event is sales to customers, the tax is separately charged to customers, and Entity B receives a refund if the receivables are not collected. Entity B should therefore exclude the sales tax collected from customers from the transaction price, and no expense would be recognised for the tax. The collection and payment of the tax would only impact balance sheet accounts.

4

Property and impairment

4.1 Determining CGUs for multi-site retailers

Background

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

Issue

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

Solution

No. Conventional retail stores would typically be separate cash-generating units (CGUs), because each store generates cash inflows that are independent of other stores in the chain. 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 para 6]. IAS 36 Illustrative Examples [Example 1] consider CGUs for a chain retailer with multiple stores in the same city, although based in different neighbourhoods, and concludes that the CGU is at a store level.

An IFRS Interpretations Committee Agenda Decision in March 2007 states that 'independent cash inflow' in IAS 36 does not mean net cash flow. Cash outflows are therefore not taken into consideration in the analysis. In the case of Stores X and Y, the fact that costs are incurred centrally is not relevant.

4.2 Impairment – Value in use for retail outlet

Background

Retailer X has a number of individual retail stores which are leased. Each store has a right-of-use (RoU) asset as well as property, plant and equipment which has been added to the leased retail store in the form of leasehold improvements.

Issue

How should leased retail stores be tested for impairment?

Solution

A lessee applies IAS 36 to determine whether the leased retail store is impaired and to account for any impairment loss identified. In most cases, each leased retail store will comprise an RoU asset, as well as property, plant and equipment which has been added to the leased retail store, such as leasehold improvements and store fixtures and fittings. It is unlikely that any one of these assets could generate cash inflows independently from the others, but it is likely that together they will. Therefore, the combined store assets should be assessed for impairment as one CGU, along with an allocation of assets (such as corporate assets) that are indirectly attributable to the CGU where such an allocation can be made, on a reasonable and consistent basis.

The assets (and liabilities, where appropriate) attributed to each CGU should be consistent with the estimated future cash flows that are identified for calculating the recoverable amount. In determining the store's recoverable amount using a value-in-use (ViU) model, all future cash inflows and outflows associated with the store are included.

While RoU assets are included in a CGU when testing using a ViU model, the related lease liabilities should be excluded. This is because these are a form of financing, and all financing cash flows are explicitly excluded from ViU in accordance with paragraph 50(a) of IAS 36.

In some circumstances, liabilities cannot be separated from the related assets (for example, where a purchaser could not, or would not, acquire the asset or business without the liability). This apparent conflict was considered by the IFRIC in 2016, which noted that IAS 36 requires the carrying amount of a recognised liability to be deducted from both the carrying amount of a CGU and the amount determined under ViU without the cash outflows associated with the liability. What this means is that including the lease liabilities in the CGU would have a neutral impact on a ViU test.

The expected cash flow model will:

- Include the RoU asset in the carrying amount of the CGU;
- Exclude the lease liability from the carrying amount of the CGU because it relates to financing;
- Exclude the lease payments included in the lease liability in the ViU calculation;
- Include cash outflows to replace leased assets at the end of the lease term which are essential to the ongoing operation of the CGU (that is, the RoU asset being tested for impairment only reflects the existing lease) – refer to section 4.6 below for further guidance on cash outflows to replace leased assets in a value in use model; and
- Include cash outflows for expected future variable rents and short-term and low-value leases that are not included in the lease liability. [IAS 36 para 75]

Projected future pre-tax cash flows are discounted at a pre-tax rate that reflects both current market assessments of the time value of money and the risks specific to the asset/CGU for which the future cash flow estimates have not been adjusted. The weighted average cost of capital (WACC) might serve as a reference point, but it should reflect a market assessment of an adequate capital structure, represented by the respective peer group companies and not the entity's own capital structure. Lease liabilities would be expected to be considered as an additional debt-like element of the capital structure, in addition to existing debt and equity.

The WACC needs to reflect the peer group's capital structure. Therefore, retailers should take care to identify an appropriate peer group. In particular, the peer group should reflect entities which have a similar mix of freehold and leasehold properties in the store portfolio.

In practice, impairment testing is often performed using a post-tax discount rate. This is because observable market rates of return are generally post-tax rates, so in practice ViU is typically calculated by discounting post-tax cash flows at a post-tax discount rate as a proxy for discounting pre-tax cash flows with a pre-tax discount rate. This only works if the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows. Where there are significant temporary differences (recognised and unrecognised), the tax cash flows need to be adjusted to remove the discrepancies in this calculation. A way to deal with temporary differences when post-tax cash flows are used in practice to determine value in use, is to calculate the tax cash flows as if the tax base of the CGU's assets and liabilities were equal to their carrying amount.

4.3 Impairment – Flagship stores

Background

Retailers might invest in a cash-generating unit (CGU) that not only generates its own independent cash inflows but also provides benefits to other store CGUs within the group ('cross-subsidisation CGUs'). The cross-subsidisation CGUs can often be loss making; however, when taken together with the benefit that they provide to other CGUs, they add economic value to the entity.

For example, Retailer A opens a new flagship store in an attractive location. The store will generate independent cash inflows, but it is also designed to increase publicity for the brand and drive sales growth in other stores or increase online sales.

Issue

How should Retailer A perform an impairment test on a flagship store CGU which benefits other store CGUs in the group?

Solution

A flagship store, acting as a cross-subsidisation CGU, generates cash inflows that are independent of the cash inflows from other assets or groups of assets [IAS 36 para 6], and so it meets the definition of a CGU in its own right. An impairment test will therefore need to be performed for the flagship store if there is an indicator of impairment.

An entity generally identifies that a flagship store is a cross-subsidisation CGU when the store is initially established. It would generally be inappropriate to identify the flagship store as a cross-subsidisation CGU at a later date (for example, when there was a potential risk of impairment).

Retailer A should analyse the benefits that the flagship store provides to other store CGUs to determine what cash flows should be included in the flagship store's recoverable amount. For example, a flagship store might bear costs (cash outflows) which benefit the other stores, such as advertising and showcasing of the group's brand. In this case, the flagship store can impute an internal transfer cash inflow in the recoverable amount calculation [IAS 36 Example 1B]. This notional cash inflow should be based on 'management's best estimate of future prices that could be achieved in an arms-length transaction' [IAS 36 para 71]. It might be challenging to quantify accurately the cost savings that the flagship store generates for other CGUs. The approach to estimating the notional cash flow might depend on whether there is external evidence available for the services provided. Where there is no external or public information available, an acceptable approach might be to use the business plan approved by management at the time of investing in the flagship store (for example, the signing of the new lease contract for a flagship store), since this might help to determine what notional cash flows would be required in order to arrive at a return on investment similar to other stores in the group. The estimated internal transfer cash inflow allocated to the flagship store should be carefully monitored on an ongoing basis, in order to ensure that the flagship store provides incremental benefit to the broader business and that the notional recharge is reasonable.

Where an impairment does arise from a test, the flagship store's impairment would be the incremental loss that is not covered by actual flagship store sales plus the notional recharges.

Management should also consider if an impairment indicator is identified for the other store CGUs which benefit from the presence and activities of the flagship store. The individual impairment assessments for those store CGUs should reflect their share, on a reasonable and consistent basis, of the notional cash outflow.

4.4 Impairment – Online sales allocation

Background

Retailer X has traditionally only sold goods physically in its 50 retail stores. However, over the last 10 years, it has invested heavily in its online presence and seen exponential online sales growth in recent years as consumers continue to move their shopping preferences from store to online. Retailer X's customers are able to order their goods online from:

- Home and have them delivered to their home or other convenient collection point (that is, not one of Retailer X's stores);
- Home and pick them up from a store;
- An in-store order point and have them delivered to their home/collection point; or
- An in-store order point and pick them up from a store.

Online sales that are delivered to the customer's home can be sourced from the Retailer X's central distribution centre or from an individual store's inventory.

In the case where goods purchased online are returned, customers have the option to return the goods by post or by taking the goods to a store.

Issue

How should online sales and returns be allocated to a retail store when assessing that store (CGU) for impairment?

Solution

IAS 36 requires identification of CGUs for impairment testing purposes that are the 'smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets' [IAS 36 para 6]. Typically, this will be individual retail stores, because each location is considered to operate independently. The growth of online sales introduces cash flows that might or might not be independent of physical stores, and determining CGUs as well as allocating such online sales to stores/CGUs can be difficult to apply in practice, and judgement might be required.

In order to evidence that a sale is derived from a particular retail store, it is important that there is a demonstrable and direct link between the sale and the store.

In the fact pattern outlined in the question above, Retailer X concludes that it is appropriate to include the following cash inflows in an impairment assessment of a store CGU as follows:

- Goods ordered online from the customer's home and delivered directly from a specific store to the customer or to an agreed collection point serviced by a specific store would be allocated to the specific store CGU – the link between online order and store is established, because the store provides the goods. However, sales ordered online from the customer's home and delivered from a central warehouse would not typically be allocated to a specific store, even if the customer has them shipped to a location in the vicinity of a specific retail store or the customer's shipping address is closest to a particular store.
- Goods ordered online from home by the customer and picked up by the customer directly from a store CGU – the link between sale and store is established, because the store typically sells the product and the customer picks it up from that store.
- Goods ordered online from an in-store order point (that is, in the store CGU under review) and delivered directly to the customer's home – in this case, it might not matter whether the goods are shipped from a central warehouse or from the store directly, because the link between sale and store has been established by the fact that the customer ordered the goods from the store's premises itself and the store typically sells these products.
- Goods ordered online from an in-store order point (that is, in the store CGU under review) and picked up from that store – in this case, the link between the sale and store is clearly established.

In these cases, Retailer X has a demonstrable and direct link that evidences that these sales are derived from a particular store (in other words, the goods are either ordered from that store and/or picked up from that store), with the exception of the case where a customer orders from home and the goods are being shipped from a centralised warehouse to the customer's home.

There might be other, different ways in which customers can order and receive products, and different ways in which retailers will distribute the product. Each entity needs to make a judgement about whether there is a demonstrable and direct link between a store and an online sale. Only if such a link is established and evidenced can online sales be allocated to a particular store. To the extent that it is material, entities should disclose the approach as part of their accounting policies and consider whether the policy represents a significant accounting judgement, as defined by IAS 1.

The principle of comparing 'like for like' applies to the cash outflows associated with returns. Cash outflows associated with goods that are returned to a store should be deducted from the store's cash flows for the purposes of impairment only if the cash flows from the original sale were recognised as part of that store's cash inflows when assessing impairment.

4.5 Impairment – Allocation of head office costs and assets

Background

Entity X has 20 leased retail stores. The stores offer in-store sales, and customers can also order shopping online. Entity X owns a separate headquarter building and a central warehouse. These corporate assets house various typical functions such as marketing, advertising, IT, HR, payroll, accounting, administration etc. One of the stores (Store Y, a CGU) is loss-making, and management is looking at testing this store for impairment.

Issue

What should be considered – with regard to online sales, head office costs and corporate recharges – in determining the value in use for the purpose of testing Store Y for impairment?

Solution

Online sales that are directly attributable to Store Y should be allocated when assessing that store for impairment. Such sales would include sales that were ordered online and subsequently collected in Store Y. See FAQ 4.4 for more guidance on allocating online sales and returns.

Cash flows should also include projections of future overheads in relation to head office functions, as well as central warehousing that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the store, in accordance with paragraph 41 of IAS 36.

In accordance with paragraph 102 of IAS 36, corporate assets that relate to the Store Y CGU should be identified, and a portion of the carrying amount should be allocated to Store Y if it can be allocated on a reasonable and consistent basis to this store.

Any allocation is inherently judgemental and it is important to ensure that corporate overheads are not omitted or double counted in the value in use calculations. For example, if part of the carrying value of a corporate property is allocated to Store Y for the purpose of the impairment review, any internal management charges paid by Store Y relating to the use of that property should be excluded from their cash outflows, where inclusion would result in double counting.

4.6 Impairment – Replacement cash flows for leased assets

Background

Entity A has a right-of-use (RoU) asset within a cash generating unit (CGU). The lease cash outflows in respect of this lease should be excluded from the CGU cash flows in a value in use (ViU) model, because paragraph 50 of IAS 36 excludes cash flows from financing activities. The CGU requires an equivalent asset after the lease ends to continue operating, and so Entity A should include the replacement of the lease asset as a cash outflow in a ViU model. If the use of replacement assets is expected to continue for the foreseeable future, cash outflows might need to be reflected in the terminal value.

Issue

What are the practical ways to include cash outflows to replace leased assets in a ViU model?

Solution

Entity A has the option to either purchase a replacement asset via capital expenditure or enter into another lease for a similar asset.

Irrespective of the method chosen by management for financing the acquisition of the replacement asset (that is, purchase or lease renewal), the ViU model should include cash outflows for replacement of the asset in the year in which the existing lease expires and in subsequent years. The modelling might be complex for CGUs with large RoU asset portfolios.

One of the possible practical solutions is to use annual depreciation of the CGU's RoU assets as a proxy for replacement asset cash outflows after the lease term. This simplification is only possible for 'steady state' lease portfolios (relatively constant flow of renewals). Inflation should also be considered, because depreciation is a historical measure. Where inflation is not negligible, depreciation should be inflation-adjusted to avoid understatement of future cash outflows.

This method can be illustrated by the following simplified example. At 31 December 20X0, Entity A has a lease with an annual lease payment of CU100 a year and an RoU asset of CU190 with a useful life of 2 years (the remaining lease term) and annual depreciation charge of CU95. The existing RoU asset would depreciate to nil over Years 1 and 2.

ViU model	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
CGU assets	Existing RoU asset in CGU		Replacement leased asset not in the CGU assets being tested.			
	Lease payments excluded from cash flow		Cash outflows will be included for replacement of the asset on expiry of the existing lease. RoU asset annual depreciation charge might be used as a proxy			
ViU cashflows	Exclude cash outflow of CU100	Exclude cash outflow of CU100	Include cash outflow of CU95 adjusted for inflation	Include cash outflow of CU95 adjusted for inflation	Include cash outflow of CU95 adjusted for inflation	Include cash outflow of CU95 adjusted for inflation in calculation of the terminal value

This method is only one of the possible approaches, and other methods might be appropriate. For example, this method might not be appropriate for lumpy lease portfolios, in which case more detailed forecasting would be required.

4.7 Depreciation of an idle asset

Background

As a result of government regulations, Retailer Y is not permitted to open its leased store for a period of time. In addition, access to the store is limited, and Retailer Y is not permitted to do any renovation work in the store or use the store as a warehouse for online sales; however, goods remain stored in the premises. Retailer Y depreciates the right of use (RoU) asset in accordance with IAS 16, which results in depreciation on a straight-line basis or another systematic basis that is more representative of the pattern in which the entity expects to consume the RoU asset. For this RoU asset, the predominant limiting factor is the period of time for which the lessee has contractual rights to use the underlying asset over the lease term, so it is therefore depreciated on a straight-line basis.

Issue

Can Retailer Y stop depreciating an asset if it is idle?

Solution

During the period of the closure, it would not be appropriate for Retailer Y to stop depreciating the RoU asset or to change its method of depreciation. This is because depreciation does not cease when the asset becomes idle under the straight-line method of depreciation.

Retailer Y applies the guidance in IAS 16 in depreciating the RoU asset. Paragraph 55 of IAS 16 requires depreciation of an asset to begin when it is available for use, and to cease at the earlier of the date when the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date when the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle, unless the asset is fully depreciated.

4.8 Sub-letting of retail space – Investment property classification

Background

Retailer C owns a property that it partially uses for its own operations as a supermarket, but some separated shops are sub-leased to other entities.

Issue

Should Retailer C treat the sub-leased areas as investment property?

Solution

An investment property is a building which Retailer C owns or leases with the intention of earning rent or holding for capital appreciation, or both. A building which is held for use in the supply of goods or for administrative purposes is not an investment property, and it is within the scope of IAS 16.

A property could be partly owner-occupied and partly held for rental income or capital appreciation. Paragraph 10 of IAS 40 acknowledges that properties can include a portion that is held to earn rentals or for capital appreciation, and another portion that is held for use in production or supply of goods or services, or administration. If the portions could be leased out separately under a finance lease or sold, an entity accounts for the portions separately.

Retailer C needs to determine if the portion consisting of the separated shops that are currently sub-leased could be sold or leased out under a finance lease. If that is the case, and Retailer C holds this portion of the property to earn rentals, that portion would be accounted for separately as investment property.

The whole supermarket would be treated as owner-occupied where the portions could not be sold or leased out as a finance lease separately unless only an insignificant portion is owner-occupied. If an insignificant portion is owner-occupied the whole building could be classified as an investment property. This assessment might require judgement.

5

Leases

5.1 Definition of a lease – Retail units

Background

Retailer A enters into a contract with a property owner that provides Retailer A the right to use an explicitly specified retail unit for a period of five years. The property owner can require Retailer A to move into another retail unit; there are several retail units of similar quality and specification available.

Because the property owner has to pay for any relocation costs, it can benefit economically from relocating Retailer A only if there is another entity that wants to occupy a large amount of retail space at a rate that is sufficient to cover the relocation costs. Those circumstances might arise, but they are not considered likely to occur.

The contract requires Retailer A to sell goods during the opening hours of the larger retail space. Retailer A decides on the mix of goods sold, the pricing of the goods sold and the quantities of inventory held. Retailer A also controls physical access to the retail unit throughout the five-year period of use.

The rent that the Retailer A pays includes a fixed amount plus a percentage of the sales from the retail unit.

Issue

Does the contract contain a lease?

Solution

IFRS 16 states that 'a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration'. In order to assess whether it has a lease, Retailer A needs to determine whether there is an identified asset and then assess whether it has both the right to obtain substantially all of the economic benefits and the right to direct the use of the identified asset.

Is there an identified asset?

The retail unit is explicitly specified in the contract. The property owner has a right to substitute the asset; however, the substitution right is not substantive, because the property owner would benefit from the exercise of the right only under certain circumstances that are not considered likely to occur. The retail unit is an identified asset. [IFRS 16 App B para B13]

Does Retailer A have the right to obtain substantially all of the economic benefits from the use of the retail unit?

Retailer A has the exclusive use of the retail unit throughout the period of use. The fact that a part of the cash flows received from the use are passed to the property owner as consideration does not prevent Retailer A from having the right to substantially all of the economic benefits from the use of the retail unit. [IFRS 16 App B para B21]

Does Retailer A have the right to direct the use of the retail unit?

During the period of use, all decisions on how, and for what purpose, the retail unit is used are made by Retailer A. The restriction that goods can only be sold during the opening hours of the larger retail space defines the scope of the contract, but it does not limit Retailer A's right to direct the use of the retail unit. [IFRS 16 App B para B24]

The contract contains a lease of a retail unit.

5.2 Retail units – Identifying components within an arrangement

Background

Retailer B leases a retail unit within a shopping mall together with shop fixtures and a storage bay. The lessor charges a fixed payment on a monthly basis. The contract indicates that the fixed payment includes: (a) the rent for the retail unit, fixtures and loading/storage bay; (b) property taxes and insurance; (c) security and cleaning; and (d) maintenance of the retail unit.

Issue

What are the components in this arrangement?

Solution

The lease components in the arrangement are the retail unit with the loading/storage bay and the fixtures. The non-lease components are the security and cleaning, and the maintenance services. [IFRS 16 para 12]

Property taxes and insurance

Applying paragraph B33 of IFRS 16, the lessee has determined that, in its specific situation, the payments for property taxes and insurance do not transfer a separate good or service, so they are not accounted for as a separate non-lease component. They are instead considered as part of the total consideration allocated to the separately identified components of the contract.

Fixtures

The fixtures are considered a separate lease component, since they are neither dependent on, nor highly interrelated with, the retail unit or loading/storage bay. This is because they can be sourced from other providers and be used in other retail units. Accordingly, the right to use the fixtures is a separate lease component.

Security and cleaning services

Security and cleaning services involve the provision of separate services to Retailer B, and they are considered as separate non-lease components. Retailer B can either:

- Separate the lease from the non-lease components, and allocate consideration to each component; or
- Apply the practical expedient, and account for both the lease and the associated non-lease component as a single, combined lease component.

Due to the significance of the maintenance services, Retailer B elects not to apply the practical expedient of combining the non-lease components with the associated lease components.

Once the lease and non-lease components are identified, contract consideration is allocated to each component. A lessee should allocate the contract consideration to the separate lease and non-lease components, based on their relative stand-alone prices.

The lessor should allocate contract consideration to the separate lease and non-lease components in accordance with the transaction price allocation guidance in IFRS 15. The practical expedient available to a lessee, for lease and non-lease components, is not available to a lessor. IFRS 15 specifies that amounts payable by the lessee for activities and costs that do not transfer a good or service to the lessee (for example, property taxes and insurance) are not separate components of the contract, but they are considered as part of the total consideration allocated to the separately identified components of the contract.

5.3 Lease term – Incidence of a termination option with a more than insignificant penalty

Background

Entity B enters into a lease contract with a lessor to lease a building on 1 January 20X1. The contract does not specify a particular contractual term but continues indefinitely until either party gives notice to terminate. Entity B and the lessor each have a right to terminate the contract, without permission from the other party, at the end of June in each calendar year, starting from 30 June 20X2, with a six-month termination notice (that is, the earliest right to terminate would be at 30 June 20X2, and the six-month notice period means that it would be effective at 31 December 20X2).

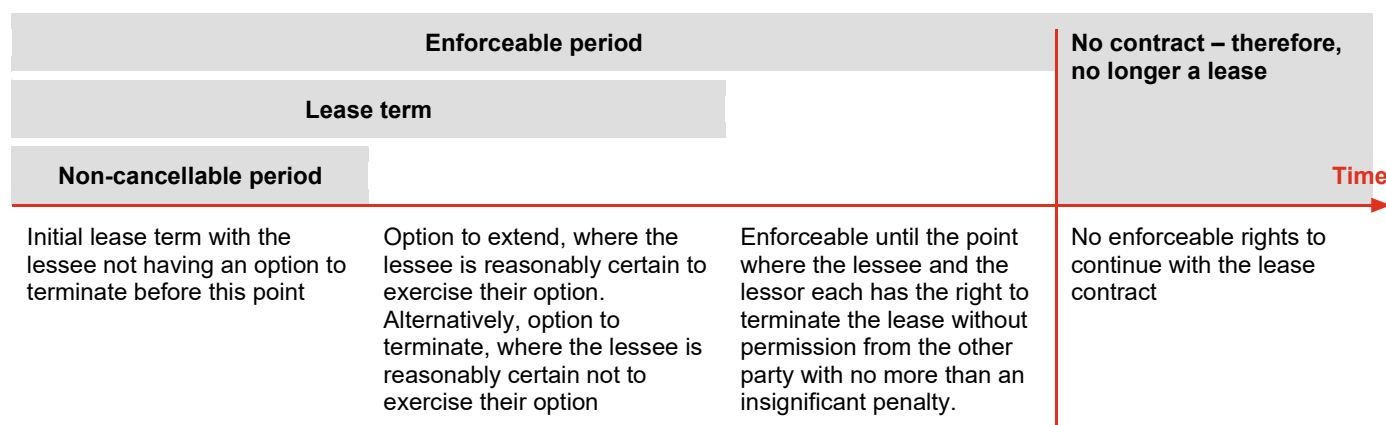
In the case where Entity B terminates the contract before the end of year 10, it has to pay a termination penalty to the lessor equivalent to two years of lease payments, which is a more than insignificant penalty. If Entity B terminates the lease after that period, no penalty is incurred. For the lessor, no termination penalty is incurred, regardless of when it terminates the contract.

Issue

What is the lease term of the contract at the commencement date?

Solution

The following diagram illustrates the lease term, and associated non-cancellable and enforceable periods:



The lease term is determined taking into account the following:

- Paragraph B34 of IFRS 16 explains that a lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Before 10 years, the lessee would incur a more than insignificant penalty to terminate. After 10 years, both parties can terminate with no more than an insignificant penalty. The enforceable period is therefore 10 years.
- The non-cancellable period is 24 months, because the lessee cannot terminate the lease with effect from a date earlier than 31 December 20X2 (considering the notice period).
- The guidance for lessee termination options should be applied, to decide what the lease term is, between a minimum of the non-cancellable period of two years (18 months + 6 months' notice) and a maximum of the enforceable period (10 years).
- The lessee's termination right within the first 10 years of the contract affects the lease term if the lessee is not reasonably certain to continue to lease the building during the first 10 years (that is, if it is reasonably certain not to exercise the termination option) [IFRS 16 App B para B37]. If the lessee is reasonably certain to continue the lease for the full enforceable period (after having taken into account all relevant facts and circumstances creating an economic incentive not to exercise the termination option), the lease term is 10 years. Conversely, if the lessee is not reasonably certain to continue the lease at a certain point in time, despite the termination penalty, the lease term ends at that point in time (taking into account the notice period).

- When evaluating whether the lessee is reasonably certain to not terminate, the termination penalty is one relevant factor. [IFRS 16 App B para B37(c)]. In this case, the magnitude of the penalty is likely to make the lessee reasonably certain to not terminate the lease before 10 years, but the entity should consider all relevant facts and circumstances (such as contractual terms and conditions for optional periods compared with market rates, significant leasehold improvements undertaken, and the importance of the underlying asset to the lessee's operations).

The IFRS Interpretations Committee ('IC') was asked how to determine the lease term of a cancellable or renewable lease, and whether 'penalty' in paragraph B34 includes only contractual termination penalty payments or should also take into account the broader economics of the contract. [IFRIC update November 2019]

The IC observed that the broader economics of the contract should be considered, and not only contractual penalty payments. Such considerations include, for example, the cost of dismantling or abandoning leasehold improvements, costs relating to the termination of the contract (such as the costs of finding a replacement lease, renegotiating or relocating), and the importance of the asset to the lessee's operations. Consequently, if either party would incur a penalty on termination that is more than insignificant at any point in time, the enforceable period would include those periods.

5.4 Perpetual leases with bilateral termination options

Background

Entity A enters into a lease of retail space. The lease continues in perpetuity, but both the lessor and the lessee have termination options. The termination options are exercisable at any time; the entity exercising the termination option will bear no more than an insignificant penalty. For both options, there are notice periods:

- If the lessee exercises its option, the termination will be effective six months after exercise.
- If the lessor exercises its option, the termination will be effective 18 months after exercise.

Issue

What is the lease term of the contract at the commencement date, and when is the lease term reassessed?

Solution

According to paragraph 18 of IFRS 16, an entity should determine the lease term as the non-cancellable period of a lease, together with both the periods covered by an option to extend the lease (if the lessee is reasonably certain to exercise that option) and the periods covered by an option to terminate the lease (if the lessee is reasonably certain not to exercise that option).

First, Entity A should determine what the non-cancellable period is, which in this case is six months. Entity A should then determine the enforceable period. A lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. [IFRS 16 App B para B34]

In this example, the enforceable period of the lease at the commencement date is 18 months. This is the period from the commencement date of the lease to the earliest point in time at which both parties can terminate the contract with no more than an insignificant penalty.

The guidance for lessee termination options should be applied to decide what the lease term is, between a minimum of the non-cancellable period (six months, the lessee's notice period) and a maximum of the enforceable period (18 months). If the lessee is reasonably certain to continue (that is, not terminate) the lease for 18 months, the lease term would be 18 months.

At the commencement date, the non-cancellable period of the contract is six months (the lessee's termination notice), and the enforceable period is 18 months. The enforceable period is effectively the period from the commencement date of the lease to the earliest point in time at which both parties can leave the contract and their contractual obligations with no more than an insignificant penalty and without permission from the other party. The lease term will therefore be determined based on the facts and circumstances specific to the lessee, between six and 18 months.

According to paragraph 21 of IFRS 16, the lease term is revised if the non-cancellable period of the lease changes. In this example, provided that no party terminates the contract, the remaining non-cancellable period of the lease is maintained at six months (such that the date on which the non-cancellable period ends changes every day to be one day later), with the remaining enforceable period maintained at 18 months (such that the date on which the enforceable period ends also changes every day to be one day later). Consequently, the remaining lease term will always be at least six months.

Alternative scenario – same facts as above, except that the lessee is reasonably certain to 'renew' for 60 months

A lessee that is reasonably certain to continue the lease during 60 months has an economic incentive to remain in the premises during that period [IFRS 16 App B para B37]. Consequently, Entity A would suffer a more than insignificant penalty if it terminated the contract before the end of the 60-month period; and, based on paragraph B34 of IFRS 16, the contract is enforceable for 60 months. The lease term is therefore 60 months (that is, the period during which the lessee is reasonably certain to remain in the premises).

5.5 Reassessment of the lease term other than when the lease contract is modified

Background

The assessment of the lease term is made at the commencement date, which corresponds to the date on which the lessor makes the underlying asset available for use by a lessee.

When a lease is not modified, the lease term should be reassessed only in limited circumstances. In particular, IFRS 16 requires a lessee to reassess extension options and termination options when a significant event or change in circumstances occurs that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option. [IFRS 16 para 20]

Issue

Which events trigger a reassessment of the lease term?

Solution

The significant events or changes that could result in a reassessment of the lease term in the retail industry could be:

- Significant leasehold improvements undertaken, or expected to be undertaken, after the commencement date: it is more likely that a lessee will exercise an extension option if a lessee makes significant investments to improve the leased asset or to tailor it for its special needs.
- Decision to extend the lease of some retail stores, when the initial term expires, taken during the preparation of the business plan that has been specifically discussed in detail and disclosed to the relevant level of governance as a key assumption of the business plan.
- Decision to sub-lease the retail store, or a significant part of it, for a period beyond the end of the initial lease term.
- Decline in the attractiveness of a commercial area, leading to the decision to close a store.
- Business decisions that are directly relevant to exercising, or not exercising, an option (such as a decision to close retail stores to focus on online sales, or the outsourcing of warehouses).

A lessee is not required to continually reassess the lease term if there is no significant event or change in circumstances. A change in market-based factors alone (for example, increases in market rents such that rents during the renewal period would now be considered a bargain) should not trigger reassessment of the lease term.

A five-year business plan signed off by the board, that assumes that the entity will exercise the extension option at the end of the initial term, is not enough to trigger a reassessment of the lease term. The board signing off the business plan is within the control of the lessee. However, the passage of time increasing the likelihood of the entity extending the lease, or an implicit assumption that the entity will extend, cannot be considered alone as a triggering event.

IFRS 16 also requires the lease term to be reassessed:

- Where the lessee exercises or does not exercise an option in a different way than the entity had previously determined was reasonably certain; or
- Where an event occurs that contractually obliges the lessee to exercise an option that was not previously included in the determination of the lease term, or prohibits the lessee from exercising an option that was previously included in the determination of the lease term.

5.6 Lease liability – Extensions option at market rates

Background

On 1 January 20X1, Entity A (lessee) enters into a lease of retail space. The non-cancellable lease term is seven years. The annual lease payment is CU10,000 in the first year, with a 5% increase in every following year, and CU10,000 reflects the market rent at the commencement date. Entity A has the option to extend the lease term for another five-year period. At the commencement date, it concludes that it is reasonably certain to exercise the extension option.

Issue

How does Entity A determine the lease payments that are included in the lease liability in the examples below?

Solution

Example A – Cap on market rent at the date when the option is exercised

The revised rent for the extension period will be agreed by the lessor and the lessee at the date when the option is exercised, based on the market rent at that time. The revised rent will, however, be no more than 105% of the rent at the end of the preceding period.

Since Entity A is reasonably certain to exercise the extension option, the lease term is 12 years. All lease payments within that period are included in the lease liability.

Because both lessor and lessee have to agree to the revised rent for the extension period, it can be assumed that the rent will be the market rent at that time. Variable lease payments that depend on an index or a rate, such as payments that vary to reflect changes in market rental rates, are initially measured using the index or rate as at the commencement date [IFRS 16 para 27]. The lease payments for the extension period that are included in the initial measurement of the lease liability are therefore CU10,000 (market rent at the commencement date) for each year of the renewal period.

	1	2	3	4	5	6	7	8–12
Lease payment [CU]	10,000	10,500	11,025	11,577	12,155	12,763	13,401	10,000

When Entity A agrees the amount of the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time.

Example B – Cap and floor on market rent at the date when the option is exercised

The revised rent for the extension period will be agreed by the lessor and Entity A at the date when the option is exercised, based on the market rent at that time. There is, however, a cap and a floor such that the revised rent cannot be below 85% or higher than 115% of the rent at the end of the preceding period. The lease payment throughout the extension period is therefore at least $(CU10,000 \times 1.05^6) \times 0.85 = CU11,391$.

In scenario B, the payments throughout the extension period are not fully variable but floored. Since the floor of CU11,391 is higher than the market rental rate at commencement date (CU10,000), the amount that is included in the initial measurement of the lease liability for years 8–12 is CU11,391.

	1	2	3	4	5	6	7	8–12
Lease payment [CU]	10,000	10,500	11,025	11,577	12,155	12,763	13,401	11,391

When Entity A agrees the amount for the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time.

Example C – Higher of year 7 rent and market rent at the date when the option is exercised

The revised rent for the extension period is the higher of (i) the rent paid in year 7 (CU13,401), and (ii) the current market rent at the date of the commencement of the extension period (either to be agreed by the lessor and the lessee, or determined by an independent surveyor).

Similar to scenario B, the payments throughout the extension period are not fully variable but floored. In scenario C, the floor is the lease payment made in year 7 (CU13,401). Since the floor of CU13,401 is higher than the market rental rate at the commencement date (CU10,000), the amount that is included in the initial measurement of the lease liability for years 8–12 is CU13,401.

	1	2	3	4	5	6	7	8–12
Lease payment [CU]	10,000	10,500	11,025	11,577	12,155	12,763	13,401	13,401

When Entity A agrees the amount of the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time if that is higher than CU13,401.

5.7 Lease modification that is not accounted for as a separate lease

Background

Retailer C enters into an agreement to modify an existing lease contract to grant the lessee the right to use additional retail space. The increase in rent is lower than the stand-alone price for the additional retail space and any appropriate adjustments.

Issue

How does Retailer C account for the modification if the effective date of the modification is before the commencement date of the new lease component?

Solution

Since the increase in consideration is not commensurate with the stand-alone price for the increased space, the lease modification is not accounted for as a separate lease. In this context, the respective discount relates to both the new lease component (additional retail space) and the existing lease component. Thus, the modification affects both the existing and the additional right of use, and it needs to be allocated to the respective components.

The lease liability relating to the existing lease is remeasured at the date of the modification. [IFRS 16 para 45]. Retailer C should remeasure the lease liability at the effective date of the modification, using a revised discount rate, and it makes a corresponding adjustment to the right-of-use asset. The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term. Retailer C uses its incremental borrowing rate at that time if the interest rate implicit in the lease is not readily determinable.

With respect to the new lease component, where the commencement date deviates from the effective date of the lease modification, the measurement of the lease liability takes place at the date of the modification [IFRS 16 para 45], whereas recognition of the additional lease component takes place at the commencement date. [IFRS 16 para 22]

5.9 Voluntary forgiveness of lease payments

The IASB issued an amendment to IFRS 16, 'Leases', to make it easier for lessees to account for COVID-19-related rent concessions such as rent holidays and temporary rent reductions. The amendment exempts lessees from having to consider individual lease contracts to determine whether rent concessions occurring as a direct consequence of the COVID-19 pandemic are lease modifications, and it allows lessees to account for such rent concessions as if they were not lease modifications. It applies to COVID-19-related rent concessions that reduce lease payments due on or before 30 June 2022. In the following example, the lessee does not apply the practical expedient on rent concessions related to COVID-19.

Background

Lessors might agree to forgive some amount of payments contractually due under a lease contract, without changing the scope of the lease or any other terms (for example, to support a lessee who is in financial difficulty).

Issue

How should such a forgiveness of lease payments be accounted for by the lessee where such reductions are not required by the contract or by laws or regulation?

Solution

IFRS 9 and IFRS 16 contain different guidance for the treatment of such voluntary forgiveness of lease payments. Therefore, we believe that a policy choice exists for such reductions.

A lessee could consider the rent reduction to be a partial extinguishment of the lease liability. Paragraph 2(b)(ii) of IFRS 9 notes that lease liabilities recognised by a lessee are subject to the derecognition requirements in IFRS 9. Paragraph 3.3.1 of IFRS 9 establishes that a financial liability should be derecognised when it is extinguished, and that includes when the obligation specified in the contract is cancelled. Under this accounting, the forgiveness would be recognised as a gain in the income statement, with a corresponding reduction in the lease liability in the period in which the reduction is contractually agreed.

Alternatively, a lessee could consider that the rent reduction is a lease modification, because there is a change in the consideration for the lease (that is, the reduction was not part of the original terms of the lease), and it could apply paragraphs 44–46 of IFRS 16. In this case, the lessee would remeasure the present value of the remaining payments required under the lease using a revised discount rate (that is, the rate implicit in the lease or the incremental borrowing rate, as appropriate) at the date of the modification, and any difference from the previous carrying value would adjust the right-of-use asset.

Entities should choose their treatment as an accounting policy and apply it consistently to amendments to contracts with similar characteristics and in similar circumstances. Entities should also take into consideration local regulators' views when selecting their accounting policy.

5.10 Lease modification following Company Voluntary Arrangement (CVA)

Background

Retailer X is in financial difficulty and has entered into a Company Voluntary Arrangement (CVA) to restructure and to hopefully avoid entering administration. As a result, Retailer X has renegotiated its lease contracts, moving from fixed lease payments to a fully revenue-based payment model. The lease contracts are for leases with terms between three and five years remaining on them.

Issue

How should the change in lease payments be accounted for?

Solution

This would be considered a lease modification, because the consideration for the lease has been changed from the original lease contracts. The modification is not accounted for as a separate lease, since the conditions in paragraph 44 of IFRS 16 are not met; there is no right of use added. Instead, the lease liability is remeasured using a revised discount rate determined at the effective date of the modification. Variable lease payments that are not based on an index or rate are not part of the lease liability, but they are recognised in the income statement when the event or condition that triggers those payments occurs. In this example, the revenue-linked lease payments would be recognised as the revenue is earned. The lease liability would therefore be fully derecognised at the date of the modification, with a corresponding adjustment to the right-of-use asset. [IFRS 16 paras 44–46].

5.11 Accounting for 'key money'

Background

Retailer C entered a long-term lease agreement for a store in a prime location. Retailer C paid 'key money' to the incumbent tenant to take over the space. Under local law, Retailer C has the right to ask for renewal of the lease at the end of the initial lease term (at rates which do not necessarily reflect market terms). If the lessor refuses the renewal, it must indemnify the lessee for the damages suffered. Alternatively, Retailer C might choose not to ask for a renewal at the end of the initial lease term, in which case it could allow a new tenant to take over the premises and would be entitled to receive key money from the new lessee.

The retailer expects to be able to recover the original amount paid when it vacates the premises, through either an indemnification from the lessor or key money from a new lessee.

Issue

How should Retailer C account for the key money paid?

Solution

Payments from a new lessee to an old lessee qualify as initial direct costs, and they are included in the initial measurement of the right-of-use asset.

When determining the subsequent measurement of the right-of-use asset, one acceptable approach is to treat the key money as a separate component of the right-of-use asset when applying the depreciation requirements of IAS 16, as required by paragraph 31 of IFRS 16. Such a treatment, in line with paragraphs 43 and 44 of IAS 16, recognises that the key money provides financial benefits over a period longer than the IFRS 16 lease term. Paragraph 52 of IAS 16 states that depreciation is recognised, provided that the residual value does not exceed the asset's carrying amount. If the retailer expects that the residual amount will be equal to, or exceed, the key money component, the depreciation charge will be zero for this component. [IAS 16 para 54]

An alternative approach is to treat the right-of-use asset (that is, including the key money) as a single asset, viewing the key money as linked to the right-of-use asset itself. The contract as a whole (including the key money) gives several rights to the tenant, which would not be distinguished under this approach, and the right-of-use asset has a residual value based on what the lessee expects to recover when it vacates the premises. Under this approach, subsequent increases in the expected recoverable amount of the key money will therefore increase the residual value of the right-of-use asset as a whole, and hence reduce the total depreciation charge.

Applying IFRS 16 to key money might represent a critical accounting judgement, in which case the lessee should consider the IAS 1 disclosure requirements.

5.12 Accounting for dilapidation and restoration costs related to a leased asset

Background

Retailer A leases a retail store and, as part of the lease contract, it is obliged to return the store in the same condition that it received it.

Issue

How should Retailer A account for obligations associated with dilapidation and restoration for a leased asset?

Solution

Mezzanine floor

Retailer A installs a mezzanine floor and recognises a provision under IAS 37 to remove it at the end of the lease. The obligation arises when Retailer A completes the improvements, which is the past event. Retailer A includes the corresponding entry as part of the right-of-use asset, applying paragraph 24(d) of IFRS 16.

Although the guidance in paragraph 24(d) of IFRS 16 is in the initial measurement section, paragraph 25 states that the restoration costs should be recognised as part of the cost of the right-of-use asset when the retailer incurs an obligation for those costs. For example, if the mezzanine floor is installed midway through the lease term, the retailer can still capitalise it into the right-of-use asset.

Dilapidations (that is, 'wear and tear')

During the lease term, Retailer A incurs wear and tear damage which it will need to repair at the end of the lease term. A provision should be made for the estimated costs of the repairs over the period of the tenancy, because:

- The tenant has a present contractual obligation, arising from the lease agreement.
- The obligating event is the wear and tear to the property, which arises over the period of the tenancy.
- The obligation arises from the wear and tear to the property, and it is not related to future operating costs.
- It is probable that the obligation will result in an outflow of economic benefits.
- It is possible to make a reliable estimate of the obligation arising from the wear and tear.
- It should be clear from the lease whether or not an obligation exists. A provision should be recognised when any damage is identified.

Retailer A should recognise the corresponding entry as an expense. The provision for wear and tear does not create an asset. The Basis for Conclusions to IFRS 16 explains that the measurement of right-of-use assets at cost is intended to be consistent with IAS 16, which only allows restoration and removal costs to be capitalised if they relate to an asset's installation, construction or acquisition.

6

Inventory and other expenditure

6.1 Accounting for distribution costs

Background

Retailer A purchases finished goods from a manufacturer and sells those goods to end-consumers in retail stores. It operates a distribution network that requires both transportation as well as storage. The storage costs include charges for depreciation of right-of-use assets and lease interest, expenses for packaging and handling as well as utilities.

Issue

Can Retailer A capitalise the costs of distribution and storage into inventories?

Solution

Paragraph 10 of IAS 2 specifies that the cost of inventories includes the cost of materials and the cost of converting those materials into finished goods. This includes the purchase price as well as all other costs necessary to bring them to their present location and condition. In this case, it would be reasonable for Retailer A to conclude that the costs incurred to transport the goods from the manufacturer to the retail store could be included in the cost of inventories. This is because the transportation is essential to put the goods on sale at a particular location in an appropriate condition.

Storage costs are generally expensed, because they are deemed unnecessary in the production process. [IAS 2 para 16(b)]. In limited cases, storage activities might constitute an unavoidable part of the supply chain necessary to bring the inventories to their present location (and be capitalised into the cost of inventory). This could be the case if they represent necessary intermediate storage for a short period to facilitate transfer of goods to the point of initial sale.

The assessment of which costs are capitalised as inventory might require judgement, to determine which costs are necessary to get the inventories to their present location and condition. For example:

- Costs incurred in transporting an item to its initial point of sale can generally be capitalised as part of the cost of inventories; but
- Costs associated with moving inventories from one point of sale to another (for example, transport of goods between stores) should generally not be included in the cost of inventories, because the goods were already in a condition and location for sale before the move.

The judgement about which cost elements are necessary costs to get the inventories to their present location and condition might be challenging in the context of a complex supply chain and/or several distribution channels.

Where an entity analyses expenses by function, paragraph 38 of IAS 2 specifies that 'cost of sales' should include costs previously included in the measurement of inventory that has now been sold, unallocated production overheads, and abnormal amounts of production costs of inventories.

6.2 Rebates and other variable consideration paid to suppliers

Background

Retailer B purchases goods for resale from a manufacturer for CU100 per unit. Retailer B receives rebates from the manufacturer based on the volume of goods purchased during each calendar period (1 January to 31 December). The rebate agreement is summarised as follows:

Scenario 1 – Rebate is on entire units purchased during the year

	Rebate on all units	Average price per unit
0–100,000 units	0%	CU100
100,000–500,000 units	10%	CU90
500,000+ units	20%	CU80

Scenario 2 – Rebate is graduated and only available on units above the threshold

	Rebate on all units	Average price per unit
0–100,000 units	0%	CU100
100,000–500,000 units	10%	CU92 (if 500,000 units purchased)
500,000+ units	20%	CU86 (if 1,000,000 units purchased)

Retailer B prepares its annual financial statements as at 31 March. During the period from 1 January to 31 March 20X0, Retailer B purchased 200,000 units. During the period from 1 April to 31 December 20X0, the retailer expects to purchase another 600,000 units.

Issue

How should Retailer B measure the cost of inventory for the 200,000 units purchased prior to 31 March 20X0?

Solution

IAS 2 does not provide specific guidance on the recognition and measurement principles for variable rebates. The right to the cash flows from the rebate is contingent on future purchases and, therefore, does not represent a financial asset. The general principles around asset recognition in other IFRS standards rely on the concept of expected cash flows (estimated based on either a weighted average or an expected outcome approach). Therefore, it would be appropriate to apply these concepts to estimating cost of inventory. IE paragraph B23 of IAS 34 supports this approach by requiring that volume rebates or discounts – and other contractual changes in the prices of raw materials, labour, or other purchased goods and services – are anticipated in interim periods, by both the payer and the recipient, if it is probable that they have been earned or will take effect.

The determination of what is probable is a judgement that might depend on a number of factors, such as the entity's experience with similar products and the factors outside the entity's control that could affect the entity's ability to make future purchases. Therefore, in some cases, it might only become probable that the rebate will be earned when the threshold is close to being met:

- Scenario 1 – Retailer B would recognise the cost of inventory for 200,000 units purchased in Q4 at CU16m, based on an average cost of CU80.
- Scenario 2 – Retailer B would recognise the cost of inventory for 200,000 units purchased in Q4 at CU17.5m, based on an average cost of CU87.50.

Estimating the amount of the rebate to be received is often judgemental. If this judgement is significant, disclosure should be provided in accordance with paragraph 122 of IAS 1 in addition to the required disclosure about estimates in accordance with paragraph 125 of IAS 1.

6.3 Allocating overhead costs to inventory

Background

The following is relevant information for Entity A:

- Full capacity is 10,000 labour hours in a year.
- Normal capacity is 7,500 labour hours in a year.
- Actual labour hours for the current period are 6,500 hours.
- Total fixed production overhead is CU1,500.
- Total variable production overhead is CU2,600.
- Total opening inventory is 2,500 units.
- Total units produced in a year are 6,500 units.
- Total units sold in a year are 6,700 units.
- Total ending inventory is 2,300 units.
- The cost of inventories is assigned by using FIFO cost formula.

Issue

How should Entity A allocate overhead costs to inventory at normal capacity?

Solution

IAS 2 states that the cost of inventories should comprise all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. Entity A should allocate fixed overhead costs and variable overhead costs to units produced at a rate of CU0.2 per hour and CU0.4 per hour respectively.

Fixed production overhead absorption rate:

= fixed production overhead/labour hours for normal capacity

= CU1,500/7,500

= CU0.2 per hour.

Therefore, fixed production overhead allocated to 6,500 units produced during the year (one unit per hour) = 6,500 × CU0.2 = CU1,300. The remaining CU200 of overhead incurred that remains unallocated is recognised as an expense.

The amount of fixed overhead allocated to inventory is not increased as a result of low production by using normal capacity to allocate fixed overhead.

Variable production overhead absorption rate:

= variable production overhead/actual hours for current period

= CU2,600/6,500

= CU0.4 per hour.

The above rate results in the allocation of all variable overheads to units produced during the year.

Since each unit has taken one hour to produce (6,500 hours/6,500 units produced), total fixed and variable production overhead recognised as part of cost of inventory:

= number of units of closing inventory × number of hours to produce each unit × (fixed production overhead absorption rate + variable production overhead absorption rate)

$$= 2,300 \times 1 \times (\text{CU}0.2 + \text{CU}0.4) = \text{CU}1,380.$$

The remaining CU2,720 ((CU1,500 + CU2,600) – CU1,380) is recognised as an expense in the income statement as follows:

Absorbed in cost of goods sold (FIFO basis) $(6,500 - 2,300) = 4,200 \times \text{CU}0.6$	2,520
Unabsorbed fixed overheads, also included in cost of goods sold	200
Total	2,720

6.4 Determining 'normal capacity' when allocating overhead to inventory

Background

Entity A manufactures business attire. Because of recent market conditions, the demand for its products has significantly decreased. As such, Entity A is projecting to operate at 50% of its manufacturing capacity for the next 12 months, and to resume full capacity thereafter. This is consistent with most other business attire manufacturers in the territory in which Entity A operates.

Entity A was unable to reduce its fixed production overheads for the next 12 months, and it was also unable to increase the selling price of its products to compensate for the higher fixed production costs per unit produced.

Issue

What factors should be considered in determining the 'normal capacity'?

Solution

Paragraph 13 of IAS 2 requires fixed production overheads to be allocated to the costs of conversion, based on the normal capacity of the production facilities. Abnormal amounts of wasted materials, labour or other production costs are recognised as expenses in the period in which they are incurred. [IAS 2 para 16]. Therefore, the costs of unused capacity and additional costs which represent wasted materials, labour or other production costs should be written off to profit or loss in the period in which they occur.

IAS 2 does not specify in detail the factors to be considered in determining the 'normal capacity'. We consider that the governing factor is that the cost of unused capacity should be written off in the current year, where such cost does not constitute a part of 'normal' capacity and where the entity does not have a fully operating facility. In determining what constitutes 'normal', the following factors might be considered:

- The volume of production that the production facilities are intended, by their designers and by management, to produce under the working conditions (for example, single or double shift) prevailing during the year;
- The budgeted level of activity for the year under review and for the ensuing years;
- The level of activity achieved both in the year under review and in previous years; and
- Although temporary changes in the load of activity can be ignored, persistent variation from the range of normal activity should lead to revision of the previous normal level of activity.

Even though Entity A expects that it will operate at a reduced capacity for the next 12 months, the normal production capacity of its manufacturing facility and the long-term plan in operating the manufacturing facility has not changed. The fact that most other business attire manufacturers have also decided to reduce production due to reduced demand does not impact this either. Accordingly, the amount of fixed overhead allocated to each unit of production should not increase because of low production or idle capacity. Unallocated overheads are recognised as an expense in the period in which they are incurred.

Management should disclose any significant judgements and estimates made in assessing whether the overhead absorption rates should be revised, or whether the additional costs should be capitalised or expensed in profit and loss, in accordance with IAS 1. Entities should also consider whether any changes in business practice might be indicators of impairment in cases where assets might become idle, or there might be plans to discontinue or restructure the operation to which an asset belongs.

It might emerge over time that the lower demand becomes a permanent feature of the market, and that Entity A as well as its competitors are unable to reduce fixed production overheads in the mid to long term. This could result in a change in what is considered to be normal capacity.

6.5 Inventory valuation – Retail inventory method

Background

Retailer C values inventory using the retail inventory method. The cost/retail value ratio used to calculate the value of inventory is based on the gross margin earned in the previous four weeks, and so it incorporates permanent markdowns.

Original inventory cost	CU60	Cost/retail value ratio for previous 4 weeks	67%
Original retail value	CU100	Current retail value	CU90

Issue

How should Retailer C apply the retail inventory method?

Solution

IAS 2 requires inventory to be valued at the lower of cost and net realisable value. The retail inventory method is a mechanism that some retailers use to value inventory, basing that valuation on the cost/retail value ratio to the retail value of closing inventory. Paragraph 22 of IAS 2 recognises the retail inventory method for inventory valuation as an approximation for cost, noting that the cost/retail value ratio should include permanent markdowns.

Retailer C should value inventory at CU60 (current retail value × 67%), using its retail inventory method. This results in an inventory valuation that approximates cost, since both the current retail value and the cost/retail value ratio used in the calculation include permanent markdowns. The cost/retail value ratio should include permanent markdowns, because excluding such markdowns could result in inventory being written down below original cost where net realisable value is in excess of original cost, which would not be acceptable under IFRS.

6.6 Inventory provisioning for expected returns

Background

Retailer A sells products for CU50 each. Customers have the right to return the products for a full refund for any reason within 90 days of purchase, with no additional restocking fees. The cost of each product is CU40. Retailer A estimates, based on the expected value method, that 10% of sales will be returned, and it is highly probable that returns will not be higher than 10%.

In accordance with paragraph B21 of IFRS 15, Retailer A only recognises revenue for those products that it does not expect will be returned. For each 1,000 products sold, Retailer A recognises revenue of CU45,000 (CU50 × 900 products), cost of sales of CU36,000 (CU40 × 900 products), and a liability of CU4,500 (10% of the sales price) for the refund obligation. It also recognises an asset of CU3,600 (CU40 × 90 products) for expected returns (with a corresponding adjustment to cost of sales),

Issue

Does Retailer A need to consider products expected to be returned when considering inventory for impairment?

Solution

Yes, Retailer A should consider the inventory expected to be returned for impairment. Paragraph B25 of IFRS 15 requires the asset to be initially measured at the carrying amount of the goods at the time of sale, less any expected costs to recover the goods and any expected reduction in value. The amount recorded as an asset should be updated for changes in the refund liability and for other changes in circumstances that might suggest an impairment of the asset.

In some instances, the asset could be immediately impaired if the entity expects that the returned goods will have diminished (or no) value at the time of return. For example, this could occur if the inventory is expected to have expired when returned, or if the inventory is expected to be 'out of season' when returned and, therefore, might need to be sold for less than cost or be destroyed.

6.7 Inventory provisioning for shrinkage

Background

Retailer B experiences shrinkage through theft or other loss. Experience shows that approximately 0.5% of all shelved stock is subject to shrinkage.

Issue

How should Retailer B account for shrinkage?

Solution

Inventories are measured at the lower of cost and net realisable value. [IAS 2 para 9]. Experienced shrinkage should be accounted for as a cost of sales. Management should measure inventories based on the actual quantities, which should be reduced to reflect any shrinkage that has occurred since the last physical count of inventory. Therefore, shrinkage should be estimated to reflect any shrinkage that has occurred since the last physical count of inventory. The entity should consider whether estimated shrinkage is a significant estimate which requires the additional disclosure required by paragraph 125 of IAS 1.

6.8 Inventory valuation – Consideration of post balance sheet events

Background

Entity C supplies certain parts to a major car manufacturer. At the year end, the entity had inventories of such parts with a carrying value of CU1 million. However, after the year end the car manufacturer changed some of their models and, as a result, the inventories became obsolete (the parts were not interchangeable between models).

Issue

Should Entity C recognise a provision against the inventories at the year end?

Solution

An entity has to determine whether developments after the reporting date provide management with better information about a condition that already existed at the balance sheet date [IAS 10 para 3]. This requires judgement and an analysis of the facts and circumstances in order to distinguish between adjusting and non-adjusting information. IAS 10 gives examples of events that require an adjustment to amounts recognised at the balance sheet date. One such example, given in paragraph 9(b) of IAS 10, refers to the sale of inventories after the balance sheet date as giving evidence of the net realisable value at the balance sheet date. The assessment of net realisable value should be updated after the reporting date if material developments provide better information than existed at the reporting date.

In this case, the entity should assess whether the car manufacturer's decision to change models was a condition that existed at the end of the reporting period. In making that assessment, the entity should consider whether the customer's decision to change the model is based on information available at the reporting date and, therefore, could have been reasonably expected at the end of the reporting period, even though the change was not completed until after the balance sheet date. If that was the case, the provision would be reflected in the carrying value of the inventories at the year end. If the entity could not have reasonably expected the change to the model, the model change would be a non-adjusting post balance sheet event. Judgement might be required to determine whether the customer's plans could have been anticipated by the supplier entity. The impact on the inventory would require disclosures to the extent material.

6.9 Inventories acquired in a business combination

Background

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

Issue

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

Solution

IFRS 3 requires inventory acquired in a business combination to be measured at fair value. The fair value of finished goods inventory is measured by determining net realisable value (that is, estimated selling prices of the inventory, less the sum of (i) costs of disposal, and (ii) a reasonable profit allowance for the selling effort), because this represents an exit price. This can be measured by reference to the price at which the inventory could be sold to customers in a retail market, or purchased from a wholesale market, adjusted for differences between the condition and location of the inventory item and comparable inventory items. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). The price that requires the least amount of subjective adjustments should be used for the fair value measurement. [IFRS 13 App B para B35(f)]

Work in progress inventory is measured similarly to finished goods inventory except that, in addition, the estimated selling price is further reduced for the costs to complete the manufacturing process and a reasonable profit allowance for that effort. Raw materials inventory is generally measured based on the price that a market participant would pay currently for the inventory. The market participant price of raw materials is generally already reflected in the acquired entity's carrying value, particularly for inventory recently purchased.

The amount recognised for inventory acquired in a business combination at fair value will generally be higher than the amount recognised by the entity being acquired before the business combination. This is likely to be the case where an entity acquires another entity that manufactures products. In the case of Retailer A's acquisition of Retailer B, however, careful consideration would be required of other factors to determine the adjustment to historical cost. For example, in the case of inventory with a short shelf life (such as fresh food), there are generally no significant future selling efforts. Therefore, a significant portion of the difference between the historical cost and the ultimate selling price could be considered a 'reasonable profit allowance' for selling efforts, and therefore historical book value could approximate fair value.

6.10 Capitalisation of development costs

Background

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

Issue

Are the development costs incurred by Entity C capitalised as an intangible asset?

Solution

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

Paragraph 57 of IAS 38 specifies that development costs should be capitalised as an intangible 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.

An intangible asset must be identifiable and attributable to a specific product or project in order to meet the recognition criteria for an intangible asset. Management should be able to identify the future economic benefits that will flow from each separate intangible asset that it recognises. It is not possible to meet the recognition criteria for an intangible asset if management is unable to identify the individual product or project.

Entity C should capitalise costs after the criteria are met. It is sometimes difficult to determine the point at which the criteria are met. The entity would need to map its development 'stage-gate' process to the above criteria, to determine if and when the criteria to capitalise costs are met.

In that process, Entity C would also need to clearly differentiate between research and development costs. IAS 38 defines 'research' as the 'original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding'. Research costs are expensed as incurred; this is because, in the research phase of the project, the entity will not yet be able to demonstrate that an intangible asset exists that will generate probable future economic benefits.

Expenses incurred before a project meets the criteria for recognition as an intangible asset must be expensed as incurred. Previously written-off costs cannot be reinstated as part of the intangible asset if the project has reached the stage at which an asset must be recognised.

6.11 Useful life of brands

Background

Entity A sells luxury goods and has acquired two fragrance brands for its product range:

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

Issue

An intangible asset has been recognised for each brand. Should Entity C account for brands as having an indefinite life?

Solution

Intangible assets have an indefinite useful life where there is no foreseeable limit to the period over which, based on an analysis of all relevant factors, the asset is expected to generate net cash inflows for the entity [IAS 38 para 88]. In this situation, factors that might be considered separately for each fragrance include:

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

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 music 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.

Indefinite-lived intangible assets should be reviewed annually, to confirm whether or not events and circumstances still support the assumption of an indefinite life. If they do not, the change from indefinite to finite useful life should be accounted for as a change in estimate under IAS 8. [IAS 38 para 109]

6.12 Advertising expense and catalogues

Background

Entity B advertises through an annual catalogue which is mailed to existing and potential customers.

Issue

Can Entity B recognise an asset for a catalogue that has been prepared but not yet sent?

Solution

The primary objective of mail order catalogues is to advertise goods to customers rather than to give rise to a distribution network. Mail order catalogues are an example of advertising activities and cannot be capitalised [IAS 38 para BC46G]. Further, if the catalogue of products was marketed through other means (such as television, internet or the entity's website), costs to produce and develop this marketing should be expensed immediately, unless the spend was on services not yet received (for example, prepaid advertising), in which case a prepayment would be recognised on the balance sheet until those services are received.

An entity should not recognise an asset in respect of an advertisement that it has obtained but has not yet published. The only economic benefits that might flow to the entity as a result of publishing the advertisement are the same as those that might flow to the entity as a result of the brand or customer relationship that it would enhance or create. The entity should not recognise as an asset goods or services that it has received in respect of its future advertising or promotional activities. [IAS 38 paras BC46B–BC46C]

Advertising and promotional activities enhance or create brands or customer relationships, which in turn generate revenues. Goods or services acquired to be used in advertising or promotional activities have no other purpose. The only benefit of those goods or services is to develop brands or customer relationships, which in turn generate revenues. Internally generated brands and customer relationships are not recognised as intangible assets.



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