Technical Guide on

Accounting Issues in the Retail Sector

Research Committee
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

The retail sector of Indian economy is going through a phase of tremendous transformation. Traditionally, the sector has been divided into unorganised and organised sectors, with unorganised retailers like the traditional family run stores and corner stores being the order of the day. However, the organised retail sector is now catching up very fast. The emergence of shopping malls, stores like convenience stores, mini marts, hyper marts, mini and large supermarkets are taking the major share in food sector, non-food sector and other products. These stores have earned the reputation of being 'super saver locations' and the infrastructure of the retail sector is evolving radically. In the last few years, owing to change in consumer profiles and demographics, improvements in the standard of living, increase in per capita income, availability of various sources of financing, improvements in infrastructure and enhanced availability of retail space has led to phenomenal increase in the entry of international labels, expansion in retail plans with increased focus on technology, operations and processes.

The nature of transactions entered into the organized retail sector have certain peculiarities having specialised accounting implications. A need was, therefore, being felt for specific guidance to suggest appropriate and uniform accounting treatment in this sector. Keeping this in view, I express my appreciation of the Research Committee of the Institute for taking up a project to study the sector and formulate the 'Technical Guide on Accounting Issues in the Retail Sector'.

I would like to record my appreciation of the efforts put in by CA. Bhavna G. Doshi, Chairperson, Research Committee, in the formulation of this Technical Guide.

I am confident that this technical guide will be extremely useful to the members of the Institute in discharging their professional duties and also to the preparers of the financial statements and others concerned.

New Delhi
May 21, 2012

CA. Jaydeep Narendra Shah
President

Preface

Organised retail with modern formats has seen tremendous growth in India over past few years with India ranked as the third most attractive nation for retail investment among 30 emerging markets by the US-based global management consulting firm, A T Kearney in its 9th annual Global Retail Development Index (GRDI) 2010.

The new formats of trade has brought to fore various complex accounting issues like accounting for customer loyalty programmes, arrangements with vendors/manufacturers, valuation of inventories and so on where guidance was considered useful to enable businesses to adopt uniform accounting norms while applying accounting standards given special features and modes of modern trade and also to facilitate auditors of these entities in the wake of varying practices adopted by businesses in applying accounting standards. The Technical Guide also provides Ind-AS perspective of the accounting issues in view of the proposed convergence of Indian Accounting Standards with International Financial Reporting Standards.

I would like to place on record my sincere appreciation for the contribution made by CA. Harinderjit Singh and CA. Madhuri Shahapure who prepared the basic draft of this Technical Guide. I would also like to place on record the contribution made in this initiative by CA. Charanjot Singh Nanda, the Vice-Chairman of the Committee and other members of the Research Committee. I would also like to make special mention of the significant contribution made by the representatives of the retail industry who actively participated in the discussions during preparation of this Technical Guide.

This publication could not have been possible but for the support and encouragement of CA. Jaydeep N. Shah, President, ICAI and CA. Subodh K. Agrawal, Vice-President, ICAI. I would like to place my sincere appreciation for their guidance during the course of this work.

I am sure this Technical Guide will prove useful to all the stakeholders and look forward to suggestions to further improve this publication and to keep it current.

New Delhi
May 18, 2012

CA. Bhavna G. Doshi
Chairperson
Research Committee

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1. Introduction

1.1 The retail industry in India has evolved significantly in the last few years from the neighbourhood 'mom-n-pop' shops to exclusive brand outlets, supermarkets and even hypermarkets. This has resulted in a vast change in the business environment and has led to significant complexities in accounting and financial reporting aspects as well. This Technical Guide is an initiative to address some of these complexities.

2. Scope of this Technical Guide

2.1 This Technical Guide aims at providing a perspective on the various accounting issues which are unique to the industry. The issues are discussed in the following sections:

- Overview of the industry
- The accounting and financial reporting framework
- Complex accounting areas
  - Revenue Recognition
  - Arrangements with vendors/manufacturers
  - Inventories
  - Assets – Tangible and Intangible

2.2 This Technical Guide deals with specific accounting aspects as listed above and does not deal with other generic accounting issues commonly faced across industries. In addition to analysing the accounting issues from the point of view of existing accounting and financial reporting framework, this Technical Guide also provides a perspective under the new Indian Accounting Standards (Ind AS)[1] as well on each of the issues. All references (including paragraph references) in this Technical Guide are to the Accounting Standards notified under Companies (Accounting Standards) Rules, 2006, as amended.

2.3 **This Technical Guide is not meant to be used as a substitute for the accounting and regulatory requirements. It should be noted that it is mandatory to refer to the relevant authoritative pronouncements in all**

[1] These Standards are placed on the site of Ministry of Corporate Affairs (www.mca.gov.in)

cases. This Guide is not a comprehensive document on all the accounting issues faced by the retail industry and only deals with key issues.

3. Overview of the Industry

3.1 The rapid growth of the retail sector in India finds its roots in the underlying economic growth, population expansion, the increasing wealth of individuals and the rapid construction of organised retail infrastructure. Apart from the ever expanding middle and upper class consumer base in tier I cities, Indian retail sector is also witnessing rapid growth in the tier II and tier III cities and this has led to India being ranked as one of the most attractive nations for retail investment.

3.2 India's diversity has led to both the traditional and the modern retail to co-exist. While traditional retail provides high service levels, customer recognition, high level of specialisation, high availability percentage for key traded items, customer credit in some cases, the modern retail offers higher range, in some cases better prices, and takes responsibility for what they sell. Both traditional and modern retail adopt different operational/functional formats.

3.3 Formats differ largely based on the way they operate and consequently have their own distinct accounting and financial reporting issues. Briefly, some of these formats include:

- Convenience stores
- Supermarkets
- Hypermarkets
- Traditional departmental stores
- Full-line discount stores
- Speciality stores
- Value retailers
- Factory outlets
- Wholesale clubs
- Flea markets

3.4 These formats lead not only to a vast difference in terms of scales and volumes, but also to a large variety of revenue contracts, arrangements with manufacturers/vendors, promotional activities and infrastructure. This

Technical Guide addresses some of the significant accounting and financial reporting issues specific to the retail industry.

4 Accounting and Financial Reporting Framework

4.1 The major accounting aspects considered in this document and the corresponding Accounting Standards ('AS') are:

Revenue Recognition	Inventories	Assets–Fixed and Intangible	Promotion and Advertisement Costs/Agreements with vendors
• AS 9: Revenue Recognition	• AS 2: Valuation of Inventories	• AS 6: Depreciation Accounting • AS 10: Accounting for Fixed Assets • AS 16: Borrowing Costs • AS 19: Leases • AS 26: Intangible Assets • AS 28: Impairment of Assets.	• AS 29: Provisions, Contingent Liabilities and Contingent Assets

Where relevant, reference is also made to the Framework for the Preparation and Presentation of Financial Statements (Framework) issued by the Institute of Chartered Accountants of India (ICAI).

4.2 ***Revenue Recognition:*** Accounting Standard (AS) 9, *Revenue Recognition*, deals with recognition of revenue from:

a) sale of goods,

b) rendering of services, and

c) use by others of enterprise resources yielding interest, royalties and dividends

Ind AS Perspective

Under Ind AS, the corresponding relevant Standard is Ind AS 18, *Revenue*.

4.3 ***Inventories:*** Accounting Standard (AS) 2, *Valuation of Inventories*, deals essentially with the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised.

The application of this Standard to the unique situations in the retail sector has been stated to pose complexities.

> ***Ind AS Perspective***
>
> The corresponding Standard is Ind AS 2, *Inventories*

4.4 ***Assets:*** The retail industry is today characterised by considerable asset bases including intangible assets in the form of brands, franchisee rights, trademarks and goodwill. Complexities arise in accounting for assets not only owing to the sheer quantum but also on account of the geographical distribution of units.

> ***Ind AS Perspective***
>
> The relevant Standards under Ind AS include Ind AS 16, *Property, Plant and Equipment*, Ind AS 17, *Leases*, Ind AS 23, *Borrowing Costs*, Ind AS 36, *Impairment of Assets* and Ind AS 38, *Intangible Assets*.

4.5 ***Promotional and advertising costs/agreements with vendors:*** One of the key differentiating features of the retail industry as compared to other industries is the level of focus on innovation, customisation, multiplicity of promotional campaigns and specialised agreements with vendors. In this regard, while in simplistic terms, the expenditure is accounted for on accrual basis, there could be challenges in terms of identifying the period in which the expenditure is accrued, the mechanism used to quantify the accruals, etc. While there is no specific accounting standard prescribing the recognition and measurement principles for such costs, the requirements of Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*, are relevant.

> ***Ind AS Perspective***
>
> The relevant corresponding Standard is Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

5. Complex Accounting Areas

A. Revenue Recognition

5.1 Revenue recognition is an area of significance across all industries. In the retail industry, what sets it apart is the volume of individually small transactions aggregating to large turnover. This is further complicated by the variety in the kinds of transactions. For example, a single outlet could have

sales of various kinds including instalment sales, layaway sales, sales under different promotions and so on.

5.2 The key issues relating to revenue recognition dealt with in this Technical Guide are:

- Customer Loyalty Programmes
- Sales Returns
- Sale of gift vouchers
- Extended warranties offered by retailers
- Layaway and such other forms of sales.

Estimates assume significant importance in revenue recognition in case of retailers and has direct bearing on the amount of revenue recognised or deferred in a particular year. It also has bearing on provisions which is common to other entities as well. As a result, retailers need to create robust systems and processes to record, collate, monitor and store data in order to ascertain past trends for making estimates.

A.1 Customer Loyalty Programmes

5.3 Customer loyalty programmes are being used extensively by airlines, hotels, telecommunication operators and retailers. There are several kinds of schemes or incentive programmes that are used by retailers and based on the programmes currently used, these can broadly be classified into:

- Awards that entitle the holder to discounted/free goods or services in the same store
- Awards that the holders can use in stores within the same chain, for discounted/free goods or services
- More complex arrangements, which include award credits that entitle the holder to discounted/free goods or services provided by another entity (for example, purchases in one store earn discount coupons that can be redeemed at a food outlet, or at a store of another entity)
- Qualitative benefits such as favoured treatments/additional facilities to club members
- Arrangements in which third party organisations provide service of redeeming awards against goods or services of the issuing entity or of others.

5.4 Loyalty programmes are not directly dealt with by Accounting Standard (AS 9), *Revenue Recognition. This aspect has been dealt with under Appendix B Customer Loyalty Programmes* to Ind AS 18, *Revenue Recognition.*

5.5 The relevant extracts of AS 9 and Appendix B to Ind AS 18 are given below.

AS 9 defines revenue as:

"Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

Paragraph 6.1 of AS 9 deals with timing of recognition of revenue in case of products and reads as follows:

"A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes."

Paragraph 7.1 of AS 9 deals with timing of recognition in case of services and reads as follows:

"Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method."

Appendix B to Ind AS 18 clarifies that loyalty programmes give rise to multiple element arrangements requiring allocation of revenue between goods or services delivered and award credits that will be redeemed in future and states as follows:

"An entity shall apply paragraph 13 of Ind AS 18 and account for award credits as a separately identifiable component of the sales transaction(s) in which they are granted (the 'initial sale'). The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the award credits and the other components of the sale." (paragraph 5 of Appendix B to Ind AS 18)

"The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together." (paragraph 13 of Ind AS 18)

5.6 Appendix B to Ind AS 18 clarifies that allocation of the consideration between goods or services and the award credits is done on the basis of fair value of the award credits. It does not mandate a specific approach for estimating fair value of an award credit, but requires that it be based on the fair value to the holder and not on the cost of redemption to the issuer. The fair value of an individual award credit may be estimated using the value of discount or the free product/service that the customer would obtain when redeeming the award credit. All customers may not redeem some or all of their award credits. Appendix B to Ind AS 18 requires that the proportion of

the award credits expected to be redeemed are taken into consideration in determining fair value of a population of award credits.

5.7 Appendix B to Ind AS 18 requires that the revenue allocated to the award credits be presented as 'deferred revenue' in the balance sheet.

5.8 Most retailers in India do not treat transactions of sale of goods or service under loyalty programmes differently from normal sales without such loyalty programmes so far as revenue recognition is concerned. Appropriate provision is made, as marketing expense, towards the cost of meeting obligation arising under the loyalty programmes. This was also the practise generally followed internationally (referred to as "Provision Model" in this Technical Guide).

5.9 With greater refinements of accounting theories and especially, after issuance of IFRIC Interpretation 13[2] "Customer Loyalty Programmes", which has been incorporated as Appendix B to Ind AS 18, the accounting of sale of goods and services under loyalty programmes is also refined. Such sales of goods and services are now being considered as multiple element transactions; initial sale and future sales against redemption of the benefits under the loyalty programmes (referred to as "Deferment Model" in this Technical Guide).

5.10 Currently, both the Provision Model and Deferment Model are prevalent in India for accounting of customer loyalty programmes. Some retailers treat it as a single element transaction and recognise revenue for the entire transaction at the time of initial sale. However, since a further cost is expected to be incurred in future with regard to the obligation to provide free/discounted goods or services, a provision is recognised towards the cost of such free/discounted goods or services as marketing expense at the time of initial sale. Others treat such sale of goods or services as multiple element transactions; one element being the initial sale and another being the future sale at discounted price/free against redemption of the loyalty programmes benefit. Accordingly, revenue relating to the obligation towards award credit/future redemption of benefits under the programmes is deferred and recognised in the period in which the obligations are fulfilled.

5.11 While both the treatments are in line with the matching concept, they lead to a difference in the timing of recognition of revenue and costs. Under the first one, treating the transaction as a single element one, the total

[2] Issued by International Accounting Standards Board in June, 2007 and amended in May, 2010

revenue and total cost is recognised at the time of recognising the initial sale while under the second one, treating the transaction as a multiple element one, both revenue and costs relating to the loyalty programmes are recognised subsequent to the initial sale when the related obligations are fulfilled.

5.12 View that is now emerging post issuance of IFRIC 13 and the issuance of Ind AS 18, that multiple element treatment of loyalty programmes is also consistent with AS 9 on the basis that AS 9 prescribes recognition of revenue when and to the extent that, goods and services have been provided to the customer. In case of sale of goods and services which entitle the customer to points or award scheme/benefits/ rights which can be redeemed in future for discounted or free goods or services, the retailer has two obligations – firstly, to provide the initial goods or services and secondly, to provide further goods or services at a discounted price or even free of cost as and when customer redeems the award/benefit of the programmes. Accordingly, the consideration received is towards fulfilling two obligations rather than just providing the initial goods or services.

5.13 The Deferment Model being more refined one is preferred model, though it does involve complex workings to arrive at the fair value of the award credits/obligations to be fulfilled in future. This Model thus, requires data for estimating the expected redemptions to establish patterns which may not be readily available with a retailer especially, since organised retail is comparatively new in India. In case, reliable data is not available or the estimation of fair value of award credits presents significant difficulties, Provision Model may be used.

A.1.1. Awards that entitle the holder to discounted/free goods or services in the same store

5.14 The concept of bifurcating the two elements of a transaction and accounting treatment for each element under the Deferment Model is explained in the following illustration:

Illustration 1: Award credits – Deferment Model

Entity A awards 80 points with each purchase of goods of Rs. 100. These points can be exchanged for goods supplied by the entity. The customer has a three year period over which he/she can use the credits. For every 1,000 points, goods with a retail sale price of Rs. 60 can be obtained. If the entity provides these goods itself, its cost is Rs. 12. The Entity has sold goods of Rs 150 under the Scheme. It has thus, awarded 120 points in connection with

sale of goods of Rs.150. In Year 1, the Entity expects that 100 of these points will be redeemed. In Year 2, the Entity revises its estimate of estimated redemption to 90 points. The actual redemption is as under:

Year 1: 50 points redeemed

Year 2: 10 points redeemed

Year 3: 30 points redeemed or expired

<u>Deferment Model</u>

First of all, value of the Award Credits will need to be worked out. This works out to Rs 7.20 [(60*120/1000)]. However, since only 100 points are expected to be redeemed, the fair value of the total award credits works out to Rs.6 (Rs.7.2 *100/120).

The accounting treatment for this will be as under:

<u>At the time of initial sale</u>

Cash/Bank	Dr		Rs.150	Cash received at the time of sale
Deferred revenue		Cr	Rs.6	Fair value of the award [7.2 * (100/120)]
Sales		Cr	Rs. 144	Rs. 150 – Rs. 6

<u>At the end of year 1:</u>

Since 50 points have been redeemed, the entity will recognise revenue of Rs.3 (50/100*Rs.6). Rs. 6 is the initial estimate of the fair value of the award which was deferred at the time of sale on the basis that 100 points will be redeemed.

Deferred revenue	Dr		Rs.3	(50/100*Rs.6)
Sales		Cr	Rs.3	

Correspondingly, as and when the points are redeemed, the entity will book the cost incurred towards redeeming the points. The entity incurs Rs.12 when it redeems 1000 points, accordingly, for 50 points the cost is worked out to Re. 0.60 i.e. (50/1000*12):

Cost of good sold	Dr		Re.0.60	(50/1000*Rs.12)
Inventory		Cr	Re.0.60	

<u>Year 2:</u>

During the second year, 10 points have been redeemed, bringing the total points redeemed to date to 10+50 = 60. Since management now expects a

total of 90 points to be redeemed, it should recognise a revenue of Rs. 4 i.e. (60/90*Rs.6). As Rs. 3 has already been recognised, the company recognises a further Re.1 of the revenue. The entries in year 2 will be as follows:

Deferred revenue	Dr		Re.1	Revenue to be recognised till date: 60 points/90 points *Rs.6 = Rs.4 Less: recognised in Year 1: Rs.3.00 ***Balance: Re.1.00***
Sales		Cr	Re.1	

Correspondingly, the entity incurs Rs.12 when it redeems 1000 points, accordingly, for 10 points the cost is worked out as (10/1000*12) which is Re.0.12.

Cost of goods sold	Dr		Re.0.12	(10/1000*Rs.12)
Inventory		Cr	Re.0.12	

Year 3:

Since the remaining points are either redeemed or expired in the third year, the balance of deferred revenue should be recognised in this year. Since out of the total deferred revenue of Rs. 6, Rs. 4 has been recognised as revenue in the earlier years, the balance of Rs. 2 of deferred revenue is recognised in year 3. Further, if the balance points are not redeemed and they expire, then there will be no corresponding cost. However, if the balance points are redeemed, then the corresponding costs should also be recognised as illustrated for year 1 and year 2.

Deferred revenue	Dr		Rs. 2	Total deferred revenue: Rs.6.00 Less: recognised in Year 1: Rs.3.00 Less: recognised in Year 2: Re.1.00 ***Balance: Rs.2.00***
Sales		Cr	Rs. 2	

Accordingly, the impact of using the Deferment Model is that Rs.6 out of the revenue received in Year 1 is recognised over 3 year period in proportion to

the expected redemptions. The total revenue recognised over the 3 year period continues to be Rs.150. The related costs of redemption are recognised correspondingly in the respective period when the redemption occurs.

Provision Model:

In contrast, under the Provision model, the entire revenue is recognised at the time of initial sale, along with the entire expected cost of redemption for which a provision is recognised:

Cash/Bank	Dr		Rs. 150	Cash received at the time of initial sale
Sales		Cr	Rs. 150	Revenue recognised fully
Marketing expense	Dr		Rs. 1.20	Expected cost of goods to be used for redemption of 100 points: [Rs.12*100 points /1000 points]
Provision for marketing expense		Cr	Rs. 1.20	

As and when the points are redeemed in the subsequent years, the provision recognised as above is utilised. For example, in year 1, since 50 points are redeemed, provision for marketing expense is utilised as follows:

Provision for marketing expense	Dr		Re. 0.60	(50/1000*Rs.12)
To Inventory		Cr	Re. 0.60	

5.15 The difficult aspect in this process is the determination of the fair value of the points/award credits. This is further illustrated in the following example:

Illustration 2: Awards credits – identification of fair value

A retailer sells a toy for Rs. 20. A voucher entitling the bearer to a discount of Rs. 6 on a subsequent purchase of the same type of toy is issued with each sale. Another retailer sells the same toy for Rs. 18 without the voucher. The retailer's experience has been that for every two vouchers issued, one is redeemed. During a particular year, the retailer has sold 10 toys with vouchers.

In this case, the customer is purchasing both the toy and the voucher. Therefore, revenue will be required to be allocated between the toy and the voucher (coupon). This is done using fair values of each element.

The fair value of each voucher is worked out to Rs.4 as under:

Normal sale price of the toy without voucher	Rs. 18
Less: Sale price of toy using voucher (Retail price of Rs. 20 less the face value of the voucher Rs. 6)	Rs. 14
Redemption value of the voucher	Rs. 4

This value is then adjusted for the proportion of vouchers expected to be redeemed (50 per cent). Thus, the fair value of the Voucher works out to Rs. 2 (Rs. 4*50 %) and that of the toy to Rs. 18 (Rs. 20 minus Rs. 2 being the fair value of the voucher)

The accounting entry at the time of initial sale will be as under:

Cash/Bank	Dr		Rs. 200	Cash received at the time of sale (10 toys @ Rs. 20 per toy)
Sales		Cr	Rs. 180	Fair value of the toys*Rs.18 per toy
Deferred Revenue		Cr	Rs. 20	Fair value of the voucher (10 vouchers @ Rs.2 per voucher)

The amount of revenue recognised upon redemption of the vouchers is based upon the Redemption Value of the vouchers.

Hence, when a single voucher is redeemed the accounting entry is:

Deferred Revenue	Dr		Rs.4	Redemption Value of each voucher
Cash/Bank	Dr		Rs.14	Cash received at the time of sale (Sale Price Rs. 20 minus Rs. 6 – face value of the voucher)
Sales		Cr	Rs.18	Redemption Value of voucher (Rs. 4) + amount received on sale (Rs. 14)

A.1.2. Award Credits that the holders can use in stores within the same chain, for discounted/free goods or services

5.16 The same principles as set out above in relation to award credits entitling the holder to discounted/free goods or services in the same store apply in this situation also except that the determination of the fair value of the award credits, goods or services will need to take into consideration the difference, if any, in the price at which the goods or services are sold in different stores.

5.17 In case Provision Model is adopted, the provision will have to take into consideration the difference, if any, in the cost of goods or services supplied by different stores.

A.1.3 Award credits that are redeemable against discounted/free goods or services provided by the issuer entity itself or for goods or services provided by another entity.

5.18 There could be a reciprocal arrangement too whereby the issuing entity redeems awards issued by the third party.

5.19 Such loyalty programmes may be administered by the issuer entity itself or the obligation and/or administration may be transferred to third party.

The accounting of self administered programmes is illustrated below.

5.20 Where the customer can redeem awards issued by an entity at its own store or at a third party store, the entity retains the obligation for redemption till the point the customer redeems the award. This is because the customer is free to redeem the points in either own or third party stores. In such cases, it may or may not be possible to estimate how many points the customer is likely to redeem in own store and how many in third party store. Normal assumption is that it is not feasible to predict which of the stores the customer will choose for redemption and accordingly, it is presumed, for accounting purposes, that the customer will redeem all award credit points in own store. The accounting entries, in that case, will be same as explained above at the time of initial sale. The entity accounts for the payments to be made to the third party based on the contractual arrangement with the third party.

5.21 On the other hand, if reliable estimate for redemption pattern or choice of customers can be made based on past track record, the entity will account for the points estimated to be redeemed in own store applying principles explained above and will make provision for the amounts to be

paid to third party store based on the contractual arrangement between the parties. This is explained in the Illustration below.

Illustration 3: Award credits redeemable by another entity – self administration

Entity A awards 80 points with each purchase of goods of Rs. 100. These points can be exchanged for goods supplied by Entity A or Entity B. The customer has a three year period over which he/she can use the credits. For every 1,000 points, goods with a retail sale price of Rs. 60 can be obtained either in Entity A or Entity B. If Entity A provides these goods, its cost is Rs. 12 and if they are provided by Entity B, Entity A will have to pay Rs 40 to Entity B. Entity A has sold goods of Rs 150 under the Scheme. It has, thus, awarded 120 points in connection with sale of goods of Rs.150. In Year 1, Entity A expects that 100 of these points will be redeemed of which 60 will be redeemed in its own store and 40 will be redeemed in Entity B. In Year 2, the Entity revises its estimate of estimated redemption to 90 points of which 54 points are expected to be redeemed in its own store and 36 points in Entity B. The actual redemption is as under:

Year 1: 50 points redeemed – 30 points in Entity A and 20 points in Entity B

Year 2: 10 points redeemed – 8 points in Entity A and 2 points in Entity B

Year 3: 12 points redeemed in Entity A and balance 10 expired

<u>Deferment Model</u>

First of all, value of the Award Credits will need to be worked out. Value of 1000 points is Rs 60 so, value per point is Rs 0.06. Thus, value of 120 points works out to Rs 7.20 [(60*120)/1000]. However, since only 60 points are expected to be redeemed in Entity A, the fair value of the total award credits works out to Rs.3.6 (Rs.7.2 *60/120). Since 40 points are expected to be redeemed in Entity B, provision will have to be made for payment to be made to Entity B for the 40 points expected to be redeemed in Entity B.

The accounting treatment for Entity A for this will be as under:

<u>At the time of initial sale:</u>

Cash/Bank	Dr		Rs.150.00	Cash received at the time of sale
Deferred revenue		Cr	Rs.3.60	Fair value of the award [7.2 *(60/120)]
Sales		Cr	Rs.146.40	Rs.150 – Rs.3.60

<table>
<tr><td>Marketing Expense</td><td>Dr</td><td></td><td>Rs 1.60</td><td>Amount to be paid to Entity B (Rs. 40* 40/1000)</td></tr>
<tr><td>Provision for Redemption in Entity B</td><td></td><td>Cr</td><td>Rs 1.60</td><td>Same as above</td></tr>
<tr><td colspan="5"><u>At the end of year 1:</u>

Since 30 points have been redeemed by Entity A, Entity A will recognise revenue of Rs.1.80 (30/60*Rs.3.6). Rs.3.6 is the initial estimate of the fair value of the award expected to be redeemed in Entity A which was deferred at the time of sale on the basis that 60 points will be so redeemed.</td></tr>
<tr><td>Deferred revenue</td><td>Dr</td><td></td><td>Rs.1.80</td><td>(30/60*Rs.3.6)</td></tr>
<tr><td>Sales</td><td></td><td>Cr</td><td>Rs.1.80</td><td></td></tr>
<tr><td colspan="5">Correspondingly, as and when the points are redeemed, Entity A will book the cost incurred towards redeeming the points. Entity A incurs Rs.12 when it redeems 1000 points, accordingly, for 30 points the cost is worked out to Rs. 0.36 i.e. (30/1000*12):</td></tr>
<tr><td>Cost of Goods Sold</td><td>Dr</td><td></td><td>Re.0.36</td><td>(30/1000*Rs.12)</td></tr>
<tr><td>Sales</td><td></td><td>Cr</td><td>Re.0.36</td><td></td></tr>
<tr><td colspan="5">Further, in respect of the points redeemed in Entity B, Entity A will have to make payment to Entity B at the rate of Rs 40 for every 1000 points redeemed. As only 20 points have been redeemed, the payment by Entity A to Entity B works out to Re. 0.80.</td></tr>
<tr><td>Provision for Redemption in Entity B</td><td>Dr</td><td></td><td>Re. 0.80</td><td>Rs. (40 * 20/1000)</td></tr>
<tr><td>Cash/Bank</td><td>Cr</td><td></td><td>Re. 0.80</td><td>Amount paid to Entity B against redemption of 20 points</td></tr>
<tr><td colspan="5"><u>Year 2</u>

During the second year, 10 points have been redeemed of which 8 points are redeemed in Entity A and 2 points in Entity B. Thus, total points redeemed to date by Entity A works out to 38 (30 + 8). Since management now expects a total of 54 points to be redeemed in Entity A, it should recognise total revenue of Rs. 2.53 i.e. (38/54 * Rs.3.60). Of this, Rs. 1.80</td></tr>
</table>

<table>
<tr><td colspan="5">has already been recognised, Entity A will recognise a further Re. 0.73 of the revenue. The entries in year 2 in the books of Entity A will be as follows:</td></tr>
<tr><td>Deferred revenue</td><td>Dr</td><td></td><td>Re.0.73</td><td>Revenue to be recognised till date:
38 points/54 points *Rs.3.60 = Rs.2.53
Less: recognised in Year 1: Rs.1.80

Balance: Re.0.73</td></tr>
<tr><td>Sales</td><td></td><td>Cr</td><td>Re.0.73</td><td></td></tr>
<tr><td colspan="5">Correspondingly, the entity incurs Rs.12 when it redeems 1000 points, accordingly, for 10 points the cost is worked out as (10/1000*12) which is Re.0.12:</td></tr>
<tr><td>Cost of goods sold</td><td>Dr</td><td></td><td>Re.0.12</td><td>(10/1000*Rs.12)</td></tr>
<tr><td>Inventory</td><td></td><td>Cr</td><td>Re.0.12</td><td></td></tr>
<tr><td colspan="5">Year 3:
Since 12 points are redeemed in Entity A and balance have expired in the third year, the balance of deferred revenue should be recognised in this year. Since out of the total deferred revenue of Rs.3.60, Rs.2.53 has been recognised as revenue in the earlier years, the balance of Rs. 1.07 of deferred revenue is recognised in year 3. Further, there will be corresponding cost which entity incurs – that cost is Rs 12 for 1000 points and accordingly, for 12 points, it works out to Re 0.144 (12/1000*12).
The accounting entries in books of Entity A in Year 3 will be as under:</td></tr>
<tr><td>Deferred revenue</td><td>Dr</td><td></td><td>Rs. 1.07</td><td>Total deferred revenue: Rs.3.60
Less: recognised in Year 1: Rs.1.80
Less: recognised in Year 2: Re.0.73
Balance: Rs.1.07</td></tr>
<tr><td>Sales</td><td></td><td>Cr</td><td>Rs. 1.07</td><td></td></tr>
<tr><td colspan="5">Accordingly, the impact of using the Deferment Model is that Rs.3.60 out of the revenue received in Year 1 is recognised over 3 year period in proportion to the expected redemptions.. The total revenue recognised over the 3 year</td></tr>
</table>

period continues to be Rs.150. The related costs of redemption are recognised correspondingly in the respective period when the redemption occurs.

So far as Entity B is concerned, it will account for sales as they take place. It will recover part or no amount (depending on whether the arrangement is for discounted goods/service or free goods/service) from the customer and balance amount from Entity A.

If, however, the arrangement entered into with Entity A is onerous and it expects to incur loss in the transaction, it should make provision for the expected loss in accordance with AS 29.

Provision Model

Under the Provision Model, Entity A will recognise the entire revenue at the time of initial sale, along with the entire expected cost of redemption for which a provision is recognised:

Cash/Bank	Dr		Rs. 150	Cash received at the time of initial sale
Sales		Cr	Rs. 150	Revenue recognised fully
Marketing expense	Dr		Rs. 2.32	Cost of goods to be used for redemption in own store (0.72) + amount to be paid to Entity B (Rs. 40 *40/1000) = 1.60
Provision for marketing expense		Cr	Re. 0.72	Expected cost of goods to be used for redemption of 100 points: [Rs. 12*100 points/1000 points]
Provision for redemption in Entity B		Cr	Rs. 1.60	amount to be paid to Entity B (Rs. 40 *40/1000) = 1.60

As and when the points are redeemed in the subsequent years, the provision recognised as above is utilised. For example, in year 1, since 30 points are redeemed, provision for marketing expense is utilised as follows:

Provision for marketing expense	Dr		Re. 0.36	(30/1000*Rs.12)
To Inventory		Cr	Re. 0.36	

A.1.4. Accounting in situations where the issuer entity has transferred administration to third party

5.22 In such cases, the issuer entity retains the obligation relating to the scheme and the third party is engaged merely to act as a service provider to facilitate the administration of the loyalty scheme.

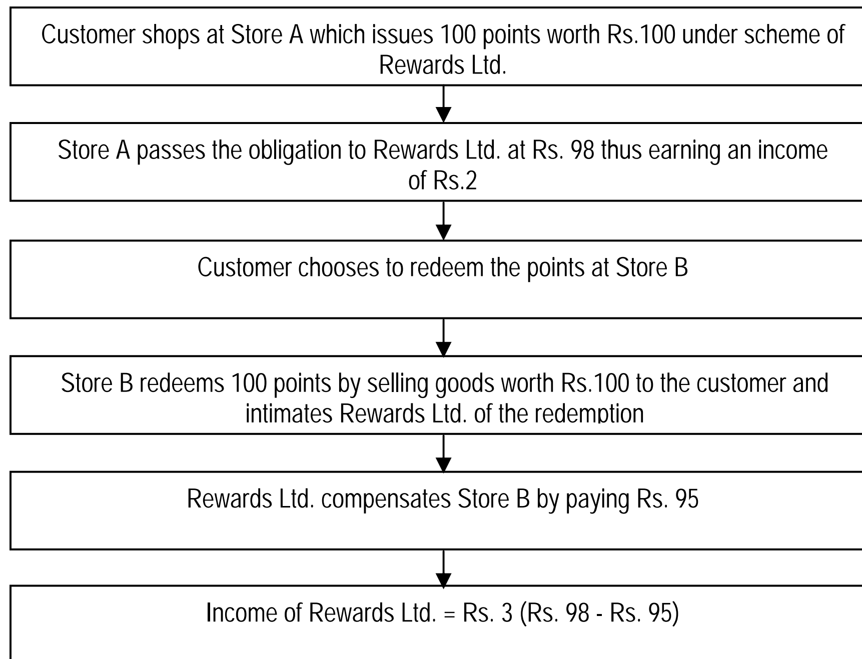
5.23 Since obligation continues to remain with the issuer entity, the principles explained above apply. The service fee of the third party for assistance in administering the loyalty scheme is to be accounted for based on the contractual arrangement between the entity and the third party.

A.1.5 Entity transfers the obligation of redeeming awards under the loyalty schemes to a third party in its entirety

5.24 The third party administrator who undertakes the obligation to redeem awards usually enters into contractual arrangements with entities participating in the scheme.

5.25 Normally, entities participating in such arrangements, act as both the issuing entity (in pursuance of its own loyalty scheme) as well as a redeeming entity (redeeming awards issued by other entities). The redeeming entity receives consideration from the third party administrator for undertaking such obligation.

The following flow chart illustrates a third party arrangement in which Store A and Store B have entered into contractual arrangement with Rewards Ltd. for administering reward schemes. Rewards Ltd has similar arrangements with multiple stores.



5.26 As the obligation is entirely passed on to the third party administrator, the issuing entity recognises the revenue in full on sale of goods/services and does not defer any revenue as there are no further obligations to be fulfilled by the entity. The expense/income on account of the transfer of obligation to the third party administrator, as per the agreement, are separately accounted for. The following illustration explains the accounting treatment in such cases.

Illustration 4: Awards obligation transferred to third party in its entirety

Rewards Ltd. runs a loyalty card scheme independently from any retailers. The customer holds a loyalty points card which is issued by Rewards Ltd. and allows the customer to earn points at a given list of retailers and use points at other retailers.

The face value of the point issued is Re. 1 and for each point issued, the issuing retailer, Store A, will pay Re 0.98 to Rewards Ltd. and in doing so will earn Re. 0.02 of commission income. Once Store A has paid Rewards Ltd., it has no further obligation to the customer.

When another retailer – Store B redeems points with a face value of Re. 1, it will receive compensating cash from Rewards Ltd. amounting to Re. 0.95. Rewards Ltd.'s margin is the difference between the redemption price and the

<table>
<tr><td colspan="5">issue price. Where either Store A or Store B both issue and redeem points, there is no netting of cash flows; cash is paid to Rewards Ltd. for points issued, and cash is received from Rewards Ltd. for points redeemed.
The accounting for such a scheme in the books of Store A is as follows:
When the retailer makes a sale of Rs. 10, it issues points with face value of Re. 1:</td></tr>
<tr><td>Cash/Bank</td><td>Dr</td><td></td><td>Rs.10</td><td>Cash received at the time of sale</td></tr>
<tr><td>Sales</td><td></td><td>Cr</td><td>Rs.9</td><td>Revenue attributed to sale of product</td></tr>
<tr><td>Other Income</td><td></td><td>Cr</td><td>Re. 0.02</td><td>Difference between obligation of Re.1 less the amount at which the liability is passed on to Rewards Ltd. Re. 0.98 = Re. 0.02. As Store A has no further obligations, it can recognise this income at the time of initial sale</td></tr>
<tr><td>Liability to Rewards Ltd</td><td></td><td>Cr</td><td>Re. 0.98</td><td>Amount determined as per the contractual arrangement with Rewards Ltd. (Re.0.98 for every point worth Re.1)</td></tr>
<tr><td colspan="5">When the risks and rewards associated with the points are immediately passed to Rewards Ltd., the liability is offset:</td></tr>
<tr><td>Liability</td><td>Dr</td><td></td><td>Re. 0.98</td><td></td></tr>
<tr><td>Cash/Bank</td><td></td><td>Cr</td><td>Re. 0.98</td><td>Money paid to Rewards Ltd. for offsetting the liability.</td></tr>
<tr><td colspan="5">The accounting for redemption in the books of Store B is as follows:
When the points are redeemed, the redeeming retailers will recognise the</td></tr>
</table>

revenue made by the points with a face value of Re. 1 at Re. 0.95:				
Receivable from Rewards Ltd	Dr		Re. 0.95	Money receivable from Rewards Ltd on redemption of voucher as per the contractual arrangement with Rewards Ltd.
Sales		Cr	Re. 0.95	
Ind AS Perspective The accounting treatment in this illustration remains the same under Ind AS 18				

5.27 The expenses relating to launching and promoting loyalty schemes should be recognised in the profit and loss account as and when incurred.

A.1.6. Change in accounting policy

5.28 Entities which have been treating loyalty programmes as marketing expenses under the Provision Model may consider changing their accounting policy in line with the treatment set out above. In this regard the requirements of Accounting Standard (AS) 5, *Net Profit or Loss for the Period, Prior Period Items and* Changes *in Accounting Policies*, paragraph 32 should be considered, which states:

> ***"Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted."***

5.29 This requirement only relates to disclosures and not the recognition on account of change in accounting policy. Accordingly, entities may either account for the change prospectively (for points to be issued from the date of change in accounting policy) and continue to account for the outstanding

points as at the date of change in accounting policy as per the earlier policy or retrospectively (for all points including the accumulated points as at the date of change in accounting policy).

> ***Ind AS Perspective:***
>
> Under Ind AS, this aspect is dealt with in Ind AS 8, *Accounting Policy, Changes in Accounting Estimates and Errors*, which requires restatement of prior year comparatives in current year financials.

A.2. Sales Returns - Right of Return in exchange for cash/goods or services/vouchers

5.30 Retailers often provide option of returning the goods for exchange either in cash or goods or services or by way of store credit vouchers which can be used by the customer for subsequent purchases, either with or without a time limit.

5.31 In such cases, the entity would need to evaluate the appropriate timing of recognising revenue as there is certain level of uncertainty attached as to when and whether the customer would exchange the goods or services and further whether the customer would utilise the vouchers, if any, obtained in exchange of returning the goods or services. While most retailers are able to discern past trends with respect to returns, others may have a varied and disparate experience of 'sales returns' and would need to make the best estimates with the available information.

5.32 With regard to uncertainties, paragraph 10 of AS 9, Revenue Recognition, states the following:

> ***"Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed."***

5.33 Further, with regard to sale of goods, the criteria set out for revenue recognition in paragraph 11 of AS 9, Revenue Recognition, are:

> ***"In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:***

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

5.34 With regard to revenue recognition for service contracts, the criteria is set out in Paragraph 12 of AS 9 states that:-

"In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service."

5.35 Following Illustration in AS 9 explains the application of AS 9 to commercial situations.

"A. Sale of Goods

....

2. *Delivered subject to conditions*

....

(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor

Revenue should not be recognised until the goods are sold to a third party."

5.36 Thus, where it is assessed that an estimated percentage of sales made could be returned, an adjustment should be made towards such estimated return.

Right of Return in exchange for cash

5.37 In cases where such right of return is provided, it is appropriate to proceed on the basis that the sales, to the extent of estimate of likely returns, have not been made. Accordingly, sales recognised during the period should be reduced by the estimate of the returns, at the gross amount of sales and a corresponding current asset should be recognised representing the inventory that may be returned. Illustration 5 below explains this aspect.

Illustration 5: Right of return in exchange of cash

Retailer Arc sells shirts with a right to the customers to return the shirts within 60 days of purchase. Returns are accepted with proof of purchase and if the shirts are unused and in good condition such that Arc can sell it as new. Historically, 10% of the Arc's sales are returned by customers and this rate is expected to continue. History has shown that all such returned shirts are resold at full price. The gross margin on sale of shirts is 5%.

Arc has several outlets in different areas and customers have option to return shirts to any outlet which refunds cash to the customer against returns, if return is in acceptable condition. Arc has sold shirts of sale value of Rs. 1000 and the period of return is not expired till the end of the financial year in which sales are made. No returns have been received till the end of the financial year. There are returns of Rs 80 in the following financial year before the expiry of return period. The accounting entries in this regard are as under.

<u>At the time of initial sale:</u>

Cash/Bank	Dr		Rs. 1000	Cash received at the time of sale
Sales		Cr	Rs. 1000	Revenue recognised to the full extent
<u>At the time of Year end</u>				
Sales	Dr		Rs. 100	10% of sales based in the past trend of expected returns
Provision for expected ' Right to Returns (Current		Cr	Rs. 100	

Liability)				
Expected returns from customers (Current asset)	Dr		Rs. 95	Cost of sales - 95% of sale price – gross margin being 5 %
Cost of Sales		Cr	Rs. 95	
In the following financial year				
Provision for expected 'right to return' (Current Liability)	Dr		Rs. 100	
Cash/Bank		Cr	Rs. 80	Cash paid on right of return exercised by the customer
Sales		Cr	Rs. 20	Balance sales (Rs.100- Rs.80) for which the period of right to return has expired
Inventory	Dr		Rs. 76	Inventory recognised to the extent of goods returned [(Rs. 80*Rs. 95)/Rs. 100]
Cost of sales	Dr.		Rs. 19	Cost of sales recognised to the extent of sales revenue of Rs 20
Expected returns from customers (Current asset)		Cr	Rs. 95	Adjustment relating to costs reversed

Ind AS Perspective

The Accounting treatment in this illustration remains the same under Ind AS 18.

Right of return against goods or services or vouchers

5.38 In the case of right of return in exchange of goods or services or vouchers giving the right to the customers to exchange the goods or services sold against other goods/services, the sales against which such right of return is given, should be treated to have been effected and simultaneously provision for expected returns should be made. Provision should be

measured as the best estimate of the loss expected to be incurred by the retailer in respect of the estimated returns including any estimated incremental cost that would be necessary to resell the goods expected to be returned.

Illustration 6 – Return of self manufactured goods

Store X is a retailer which sells goods which are self manufactured. The customers have a right to return the goods within thirty days of purchase. Returns are accepted with proof of purchase and only if they are in good condition such that X can sell it. Customers do not get cash on return but get goods or vouchers which can only be redeemed for goods against returned goods. Estimates show that 10% of all goods sold are returned/exchanged. At the end of the financial year, the period of right to return has not expired in case of goods sold for Rs. 1000. It is excepted that the returns, if any, will be sold at 90% of original sale price. The margin on sale is 20% with regard to such sale of Rs. 1,000. The accounting entries will be as under:

<u>At the time of making the sales:</u>

Cash/Bank	Dr		Rs 1000	
To Sales		Cr.		Rs. 1000

<u>At the end of the year:</u>

Nil

The reason would be that though 10% of Rs. 1000 worth of goods sold are likely to be returned as per the trend, no loss is expected as the goods are not expected to be sold below cost. (Since expected returns at sale price would be 10% of Rs. 1000 i.e. Rs. 100 and cost would be 80% of Rs. 100 i.e. Rs. 80.)

However, if it is expected that the returned goods will be sold for say 70% of the original sale price (70% of Rs. 100, i.e., Rs. 70), provision for expected loss should be made. The entry will be as under:

P&L A/c	Dr		Rs 10	
To Prov. For Expected Loss on Returns		Cr.		Rs. 10

Since as explained above, the cost is Rs. 80 and expected selling price being 70% of original sale price of Rs. 100 i.e. Rs. 70 and thus expected loss is Rs. 10.

A.3 Discount Vouchers – Promotional Campaigns

5.39 Retailers often take up promotional campaigns where they offer discount vouchers which could be distributed generally or offered against sales in their stores. Such discount vouchers entitle the customer to buy any other goods or services from the store at specified discount e.g. a retailer may circulate coupons offering discount of 20% for purchases upto specified period say, 30 days. Such offers may also entitle customer to buy other goods/services free of cost e.g. buy one get one free.

5.40 A question that arises in this context is whether such discount coupons should be considered as marketing expenses or whether revenue should be attributed to such coupons. If it is considered as marketing expense, appropriate provision for expected use of coupons is made. In some cases, it may not be appropriate to make provision e.g. where the offer is generally circulated in newspapers and reasonable estimate of likely utilisation of offer cannot be made. In such cases, the expense is recognised when the offer is actually availed. On the other hand, if revenue is attributed to it, recognition of revenue of the initial sale, to the extent of such attribution, is deferred. This is normally the case of loyalty programmes as discussed earlier. A clear distinction thus needs to be made between transactions which require deferral of revenue and those which are to be treated as marketing expense.

The distinction is made on the basis of the nature of the offer, in particular, whether the vouchers are general or linked to the specific sales or loyalty programmes. The key distinguishing features are set out below:

Marketing Expense	Revenue Attribution
No link between initial sale and offer (e.g. random distribution of discount coupons)	Clear link of the offer (products at a discount in future) with the current sale (revenue) transaction
No linkage with loyalty – the customer need not achieve any specified level of transactions or remain a customer for a specified period of time (e.g. discount of 5% offered for all purchases over Rs. 5000 during a particular weekend)	Offers (products at a discount or free of cost in future) are exercisable only after the customer has completed a specified cumulative level of revenue transactions or remains a customer for a specified period of time
Could be a combined transaction – purchase of one product entitling the	Normally, two distinct transactions at different points of time

buyer to a second product at a discount or free of cost simultaneously e.g. buy three chocolate bars at price of two	

These aspects, in respect of offers which are not onerous, are illustrated below. If the discounts are expected to exceed the costs (rare situations), the offer is treated as onerous and provision is required to be made.

Illustration 7: Discount Coupons

Quick, a clothing retailer, has launched a promotional campaign. It publishes an advertisement in a national newspaper offering a discount of 5% on any purchase over Rs. 100 in any of the retailer's stores.

Quick's normal gross margin on sales is 60%.

The accounting for such offer is as under:

The retailer does not recognise liability towards likely discounts at the time of publication of the advertisement since the distribution is very general and it cannot be reliably estimated as to if and how many persons will avail of the offer. Quick will record discount as and when customers avail of the discount against the coupon.

The cost of placing the newspaper advertisement is expensed when the newspaper is published.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS.

Illustration 8: Discount Coupons (combined purchase)

A retailer that operates a chain of pizza restaurants has launched a marketing campaign to attract new customers. The retailer distributes a series of coupons granting the customers a free dessert when they have a main course at any restaurant in the chain. The average sales price of a main course is Rs. 10 and its cost is Rs. 6. The average sales price of a dessert is Rs. 5 and its cost is Rs. 2.

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

The retailer does not recognise any provision when it distributes the coupons. It treats the costs related to the coupons as a cost of sales when customers redeem them.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS .

A.4. Gift Vouchers

5.41 Where the retailer sells gift vouchers which are unrelated to any purchases made by the customer, such sale of gift vouchers constitutes a distinct stream of receipt of funds and is accounted accordingly.

Illustration 9: Revenue from sale of gift voucher

A book retailer launches a campaign for sale of gift vouchers for festival season. The gift vouchers are sold by the bookstores at face value. The gift vouchers have no alternative use and include 'To be redeemed against purchase of books only' as one of the terms and conditions. Customers are able to exchange vouchers for any book in the store. The gift vouchers do not have an expiry date and the vouchers cannot be exchanged for cash.

The customer has to pay the balance in cash if the price of the book purchased exceeds the face value of the voucher. The store does not refund cash if the value of the voucher exceeds the value of the book.

How does the retailer account for the sale of gift vouchers?

The transaction, sale of gift vouchers is, essentially, in the nature of advance against sales. Thus, the amount received against sales is accounted as "Advance against Sales". It is not recognised as sales revenue. As and when the holder of the voucher comes for redemption of the voucher, sale takes place against which value of the voucher (advance) is adjusted since at the time of such sale, the criteria for revenue recognition viz delivery of the book against the presented gift voucher is met.

In case of unredeemed vouchers, in exceptional cases, where there is evidence that beyond a certain period of time, the vouchers are unlikely to be redeemed, the retailer may recognise revenue. Such recognition ought to be based on specific analysis of the facts and circumstances including the market practices, legal rights and historical trends.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS .

Warranties – additional or extended offered by the retailers

5.42 Retailers often sell additional warranties or extended warranties in addition to the one provided by manufacturer at the time of sale of product. An extended warranty is an agreement to provide warranty protection in addition to the scope of coverage of manufacturer's original warranty, or to extend the period of coverage provided by the manufacturer's warranty. They are often sold separately from the product but, may even be included in the price of the product.

5.43 Such sale of additional or extended warranties are, in substance, sale of separate product/service, distinct from the sale of goods/services with which the same are sold. Also, such additional or extended warranties are distinct from the original warranties offered by the manufacturer of the products. Initial or original warranties offered by the manufacturer are accounted for by the manufacturer as liability in accordance with Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets.*

5.44 The accounting treatment of sale of an extended warranty by retailer is illustrated below:

Illustration 10: Extended Warranties sold by the retailer

A retailer sells electrical goods. The goods come with a manufacturer's one-year warranty. The retailer also offers customers the option of purchasing an extended warranty to cover a further three year period after the expiry of the manufacturer's warranty.

The sales price of the extended warranty is Rs. 120. The retailer typically receives valid warranty claims from 3% of customers during the extended warranty period. The average cost of repairing or replacing the goods under the warranty is Rs. 400 per valid claim.

How is this arrangement accounted for?

As per the multiple element arrangement discussion, revenue associated with the extended warranty is deferred and recognised on a straight-line basis over the period for which the extended warranty service is provided (unless there is evidence that some other method better represents the stage of completion). Accordingly, in the year of sale, revenue of Rs. 120 is not recognised (recognition is deferred) and the same is recognised annually. Thus annual revenue of Rs. 40 (Rs.120 divided by 3) is recognised each year as income from services- 'warranty' or as 'other operating income'.

Costs incurred to fulfil the warranty obligation are charged to cost of sales as incurred.

The arrangement is monitored to ensure that the expected cost of the warranty does not exceed the amount of deferred revenue. If this occurs, the warranty contract will be onerous and a provision is recognised.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS .

Layaway sales/other forms of sales

5.45 There could be other forms of sales such as layaway sales, meaning transactions where the goods are delivered only when the buyer makes the final payment in a series of instalments. This is fairly common in the retail sector, e.g., clothing and housing goods. Revenue from such sales is recognised when the goods are delivered. However, at times, based on the specific facts and circumstances, where experience indicates that most such sales have been consummated, revenue may be recognised prior to delivery when a significant deposit is received, provided the goods are on hand, identified and in a condition to be delivered - and the risks and rewards of ownership such as price changes are transferred to the account of the purchaser – the criteria as enunciated in Accounting Standard (AS) 9, *Revenue Recognition*, are met.

B. Arrangements with Vendors/Manufacturers

5.46 While customers form one end of the spectrum, the arrangements of the retailers with vendors/manufacturers form the other end. These arrangements are of various kinds which include simplistic arrangements for lease rental sharing to complex arrangements such as minimum guaranteed revenue contracts, discount sharing contracts, etc.

5.47 Traditionally, arrangements with vendors/manufacturers mainly resulted in costs for the retailer but today, with the increasing complexities in the retail space, there are several contracts which also lead to income generation or reduction in costs. The distinction between what constitutes revenue and what leads to a reduction in costs is a critical aspect from accounting perspective as it could lead to significantly different implications.

Illustration 11: Bonus related to sale of inventory

A car dealer receives bonuses from car manufacturer when it reaches certain sales targets of motor vehicles. The sales-related bonuses are received only

after the cars are sold, that is, when they are no longer in inventory.

When can the car dealer recognise the bonus?

The bonus from the manufacturer is a contingent asset and should be recognised only when it becomes virtually certain. As it is a sales-related bonus in respect of inventory that is sold, it is appropriate to take the credit in respect of bonus so received to other operating income.

If in this illustration, the car dealer is entitled to receive bonus when he purchases more than a specified number of cars, say, 25, in a specified period, say 1 month, would it make any difference?

Yes, it will since, the bonus is related to purchase, it will constitute a quantity discount and will be reduced from purchase price of the cars. The timing of accounting will depend on the level of certainty which, in turn, will be determined by the track record of the dealer and other prevalent circumstances. If, at the time of recording purchase under the arrangement, it is virtually certain that the bonus will be available, the same is accounted, on pro-rata basis, at that time even before the target is reached.

5.48 Another aspect of arrangements with vendors or manufacturers is whether the goods are being purchased by the retailer in the capacity of a principal or whether the retailer is acting merely as an agent of the vendor/manufacturer. The recognition and revenue in either case is vastly different and hence this is another area requiring detailed evaluation.

5.49 In case of an agent, the revenue is restricted to the extent of commission on the sales only as stated in paragraph 4.1 of AS 9, Revenue Recognition in the definition of the term 'revenue' which includes the following:

".....In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."

5.50 Whether an entity is acting as a principal or an agent in transactions depends on the facts and circumstances of the relationship. The contractual arrangement between the two entities needs to be considered in order to evaluate the relationship. Some of the factors that indicate that an entity is acting as a principal in transactions could include (indicative list only):

- The customer understands that the entity is acting as the primary obligor in the arrangement.
- The entity is able to set the selling price with the customer.

- The entity has inventory risk.
- The entity performs part of the services provided or modifies the goods supplied.
- The entity has or assumes the credit risk associated with the transaction.

Illustration 12: Distributor acting as an agent

A departmental store has concessionaire outlets. The store provides the concessionaire with serviced space in the store, sales staff, point of sale equipment and stock-room space. The concessionaire pays the department store a fixed contractual fee of Rs. 10,000 per annum plus 20% of the outlet's revenue.

The concessionaire determines the stock lines sold and the prices charged to customers and has the right to move stock between its concessions in different stores. At the end of a season, the concessionaire must take back any unsold stock.

How does the department store account for this arrangement?

The departmental store, in this arrangement, is, acting as an agent and the whole of the consideration (fixed fee plus revenue share) will constitute 'commission' income in consideration for the service that it is performing for the concessionaire (making available serviced space and the service of selling in the departmental store). The departmental store has no influence over the price, does not modify the goods and bears minimal credit risk. The departmental store also does not bear the product or inventory risks.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS .

Illustration 13:

A retailer has several departmental stores which contain concessionnaire outlets. The store provides the concessionaire with serviced space in the store, sales staff, point of sale equipment and stock-room space. The concessionaire pays the department store a fixed contractual fee of Rs. 20,000 per annum and, in addition, provides stocks at 30% discount to the price at which goods are sold.

The concessionaire determines the stock lines sold and the prices to be charged to customers and has the right to move stocks between its

concessions in different departmental stores of the same retailer. The retailer has no right to return unsold stock though, in practice, the concessionaire takes back unsold stock at the end of the season if the unsold stock exceeds 40% of the stocks supplied for the season.

How does the department store account for this arrangement?

The arrangement results in two streams of revenue, one towards fee for agreeing to allow the concessionaire facilities to the concessionaire and second from sale of goods to customers

The first revenue stream being a fee is accounted as operating income in the period to which it relates. So far as the second stream is concerned, the arrangement between the retailer and the concessionaire is that of principal to principal since the inventory risk passes to the retailer. The fact that, in practice, in exceptional circumstances like very low sales the stocks are taken back, does not affect the relationship as principal. Accordingly, the retailer accounts for the price charged to the customers as sales revenue and the discounted price paid to the concessionaire as purchase cost.

C. Inventories

5.51 Inventories constitute a significant component of the balance sheet in case of any retailer and while there are no significant accounting issues relating to this area, there could be issues with respect to recognition and measurement of provision for obsolete or slow moving stock or provision for shrinkage or with regard to valuation of inventories.

5.52 Accounting Standard (AS) 2, *Inventories*, requires valuation of inventories at lower of cost and net realisable value. In terms of the costs to be considered, paragraph 6 of AS 2 states:

> ***"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."***

Para 19 of AS 2 deals with determination of costs of inventories held in retail trade and states as follows:

"The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into

consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used."

5.53 Further, for costs that need to be excluded, paragraph 13 of AS 2 states:

"In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs."

5.54 AS 2 does not specifically deal with situations of loss of inventory for retail trade. However, the principles set out in the Standard may be used for this purpose. The losses should, accordingly, be classified into normal losses and abnormal losses.

Normal Loss – Shrinkage

5.55 No separate accounting entry is required for normal losses which are automatically captured in reduced inventories at the end of a period. The inventories at the end of the period are generally determined by physical stock taking. In cases, where, there is no physical stock taking, a percentage adjustment for normal loss which is expected to have occurred by that date (in that period), is made by reducing inventory by applying this percentage.

5.56 Separate accounting is required for abnormal losses such as major theft. The same is accounted as an expense in the period in which it occurs.

Illustration 14: Shrinkage

A retailer normally, experiences shrinkage of approximately 0.5% of all shelved inventory due to theft and other inventory losses arising from handling, breakage of packing and like. This is considered as normal by the retailer.

How does management account for this shrinkage?

No separate accounting entry is required for recording such normal shrinkage. The same will be automatically accounted for at the time of physical stock taking. In case, there is no physical stock-taking, appropriate reduction to reflect the estimate of shrinkage should be made from the quantity of stock that would have occurred since the last physical stock-taking. No provision is made for future or anticipated shrinkage.

Ind AS Perspective

The requirement under Ind AS 2, is similar and inventories are measured at the lower of cost and net realisable value. In addition, there is additional guidance in para 34 of the Standard. Relevant part of it states as under:

"The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs".

Warehousing and Processing Costs

5.57 Significant costs are incurred by retailers in storing goods which are ready for sale. Retailers either store the goods in their own premises, or at times, obtain warehouses on lease or temporary basis for storage. At times, retailer incur additional costs for example, costs of sorting, repackaging, labelling, relabeling, etc. The distinction between the expenses incurred for bringing the inventory to their present location and condition and expenses incurred after this stage needs consideration in this context.

Illustration 15: Warehouse Costs

A retailer purchases finished goods and stores them in a warehouse before delivery to its retail stores. The retailer incurs storage costs for the warehouse, such as rental, depreciation and utilities.

Are these costs included in inventory or are they expensed as incurred? How does a retailer account for such intermediate warehouse costs?

Intermediate warehouse costs which are necessary to change the condition of the product so as to bring the inventory to a saleable condition as intended by the management should be included in the cost of inventory in accordance with paragraph 6 of AS 2. For example, warehousing cost for the period of storage during which grading (i.e. sorting in different categories/grades depending upon the quality, taste, texture etc.) of apples purchased in bulk is carried out in the intermediate warehouse should be included in the cost of

inventory alongwith the costs incurred for grading.

Where inventory is merely stored in warehouses and no further processing is done in the warehouse, costs related to such warehousing are not included in the cost of inventory, as these costs are not incurred to get the inventory to its present condition and location and are expensed off in accordance with paragraph 13(b) of AS 2.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS .

D. Assets-Tangible and Intangible

5.58 The assets in retail industry primarily include the retail spaces; the real estate properties including buildings and related assets in owned properties or leased premises. In either case, they are characterised by large and multiple number of properties located in different regions, at times extending across countries.

Leases in retail industry often have features like rent-free periods, renewal options on lease agreements, contingent rent, lease incentives, etc. The leases may also be financial leases or operating leases. These features are not peculiar to retail industry alone. Accordingly, leases are to be accounted for as per Accounting Standard (AS) 19, *Leases* which deals with these aspects and hence is not dealt with in this Technical Guide.

5.59 In terms of capitalisation of assets, the requirements of Accounting Standard (AS) 10, *Accounting for Fixed Assets,* need to be complied with. In the retail industry, there could be certain issues with regard to components of costs considered for capitalisation. In this regard, the requirement of paragraph 9.1 and 9.2 of AS 10 are as follows:

> "9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:
>
> (i) site preparation;
>
> (ii) initial delivery and handling costs;
>
> (iii) installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees of architects and engineers.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset."

Paragraph 23 of AS 10 states that:

"***Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance***."

5.60 One of the special features relating to retail industry is renovation and remodelling of retail stores especially, in case of super-marts/hyper-marts. Following illustration explains accounting aspects of costs incurred for such renovation/remodelling.

Illustration 16: Costs incurred in renovation and remodelling the retail store

A chain of supermarkets has acquired a new store. The new store requires significant expenditure to renovate the premises.

Management expects the renovations to take three months, during which time, the store will be closed. In the meantime, expenditure related to construction and remodelling costs, salaries of operating staff engaged to prepare the store before its opening and related utilities costs are incurred.

Which costs incurred prior to the opening of the store should be capitalised?

In line with the requirements of AS 10, the costs of construction and remodelling the store are capitalised, because these are required to bring the store to the working condition necessary for operating in the manner intended by the management; supermarket cannot be opened without incurring remodelling expenditure.

The cost of salaries of staff working on preparations for opening the store like placing orders for stocks, training of personnel, etc and related utility costs, are operating expenses. They are expensed as incurred.

Ind AS Perspective

The guidance under Ind AS 16, *Property, Plant and Equipment* is similar.

The cost of an item of property, plant and equipment includes directly attributable expenditure necessary to bring the asset to the location and condition for it to be capable of operating in the manner intended by management. These include external costs, such as delivery and installation costs, architects' fees and import duties.

Internal costs to be capitalised include directly attributable overhead costs where applicable. Overhead costs relating to unproductive or inefficient use of resources are expensed as incurred.

General administrative costs not directly attributable to the acquisition, construction or commissioning of the asset are also expensed as incurred.

5.61 As per Accounting Standard (AS) 28, *Impairment of Assets*, all entities need to test assets for impairment when indicators of impairment exist. In this regard, paragraph 6 of AS 28 states that:

> ***"An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset."***

5.62 In performing the impairment test, the recoverable amount of the asset needs to be determined which is higher of the asset's net selling price and its value in use. Recoverable amount is required to be determined for an individual asset, unless the asset forms part of a Cash Generating Unit (CGU)

Paragraph 64 of the AS 28 states that:

> ***"If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an enterprise should determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit)."***

5.63 A CGU is assigned following meaning in AS 28:

> *"A <u>cash generating unit</u> is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets."*

5.64 What constitutes a CGU poses challenges and retail sector is no different. The issues that arise in retail sector are: whether individual store constitutes a CGU or a group of stores constitute CGU, are all the stores in a specific geography constitute CGU or do all the stores of particular format say, hyper stores or stores operating under one brand/dealing with specific type of goods, say, stationery, electronic items and like constitute CGU and so on.

There are no set rules for determining what is a CGU; it is to be determined based on specific facts of a case. Following illustration explains the considerations for determining a CGU.

Illustration 17: Store identified for closure – Impairment

A retailer owns several stores across various states. Pricing, marketing, advertising and human resource policies (except for hiring cashiers and salesmen of the concerned individual retail store) are centralised. All the stores are managed in the same way; major policies are centralised though few policies are decentralised. Each store has a different customer base.

One of the stores, Store X, has not been performing as per expectations and the management has plans to close it. All the stores, including Store X, taken together are earning profits.

Is Store X which is identified for closure is a CGU or is it part of a CGU?

The key factor in identifying a CGU is whether the Store X is generating cash inflows that are largely independent of other stores.

In this case, various stores of the retailer are in dfferent locations and have different customer bases. Therefore, though each store is managed at a corporate level, each store generates cash inflows that are largely independent from those of the other stores. Therefore, Store X will constitute a separate CGU. Consequently, management should assess the store for impairment at the balance sheet date as required by AS 28.

5.65 Testing for impairment requires estimating the recoverable amount of the CGU and comparing it with its carrying amount. Recoverable amount is the CGU's net selling price or value in use, whichever is higher.

5.66 Allocation of common benefits is one of key factors in evaluating value in use. This is illustrated below:

Illustration 18: Allocation of rebates to CGUs

Group A is a retailer that sells food items in its stores throughout the country. Management purchases the food items centrally and obtains a 10% discount for large volumes purchased.

Each store would not get such a discount if it purchased the food items separately. Each store is a separate cash-generating unit.

Does management allocate the rebates received at head office to cash-generating units for determining value in use for impairment testing purposes?

Management should allocate the rebates to the cash flows of each store on a reasonable and consistent basis to reflect the rebates relevant to each CGU.

Illustration 19: Allocation of rebates to CGUs

Group A is a retailer that sells stationery items in its departmental stores throughout the country. Management purchases these stationary items centrally and obtains a 20% discount. Store X in the chain has turnover of Rs 2 crores of stationery items which constitutes 50% of the total of turnover of stationery items taking turnover of stationery items across all stores.

If the turnover of Store X is excluded, the discount will be 10 %.

Each store constitutes a separate CGU and Store X is incurring losses. Management is evaluating Store X for impairment.

What amount of discount on stationery items should be allocated to Store X for determining its value in use ?

The discount directly attributable to the turnover of stationery items of Store X is Rs 40 Lakhs (20% of Rs 2 crores). The issue that arises is should the differential discount on the turnover of the stationery items of other stores if total turnover of stationery items does not include turnover of Store X viz Rs 20 lakhs (2 Crores*20% = 40 Lakhs minus 2 crores*10%= 20 Lakhs) should be attributed to Store X?

This differential amount of Rs. 20 lakhs should be considered in determining value in use of Store X.

Ind AS Perspective

The accounting treatment in this illustration remains the same under Ind AS 16, *Property, Plant and Equipment*.