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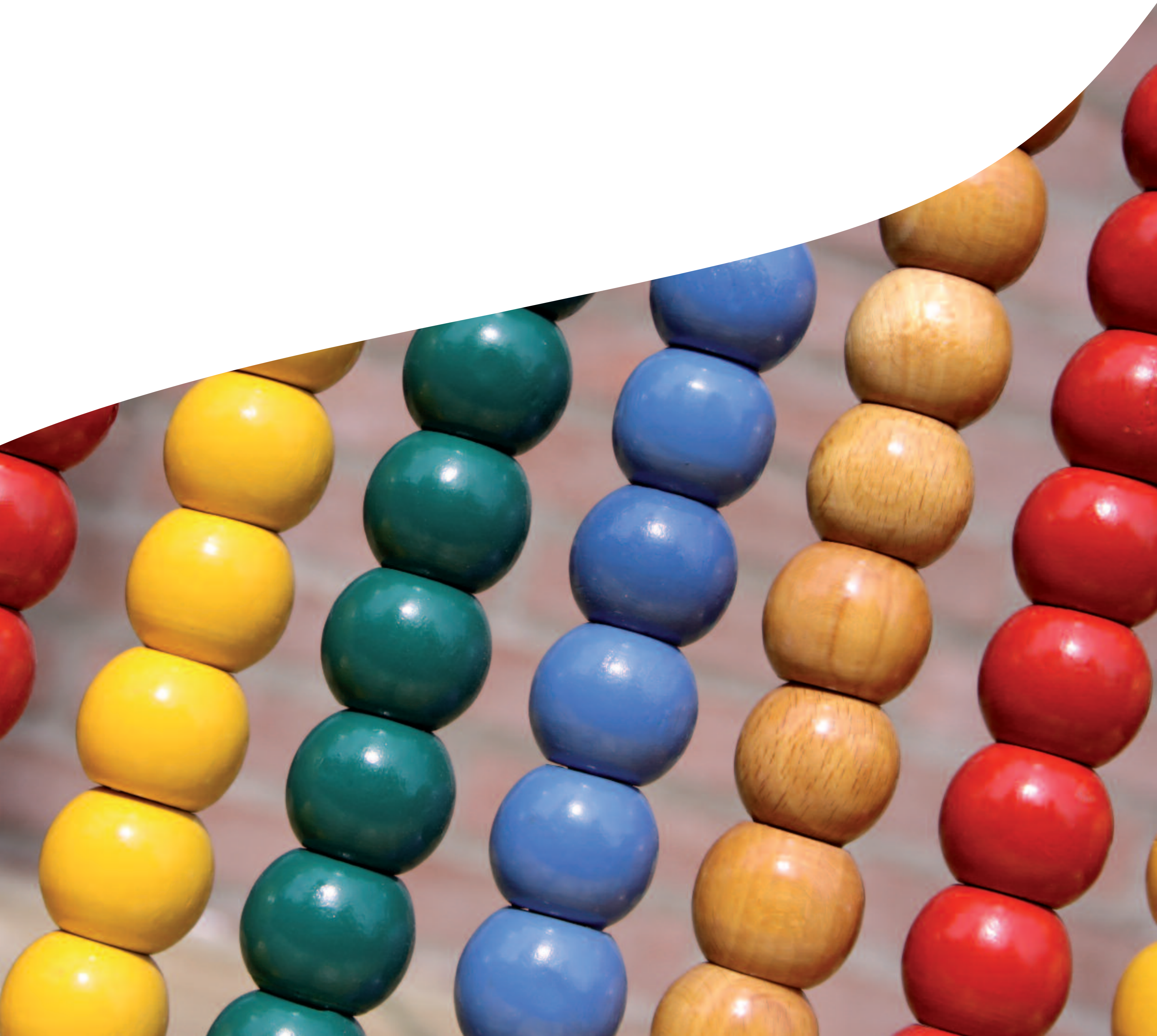
Retail | the way we see it

International Financial Reporting Standards (IFRS) and Inventory Valuation for Retail Companies



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International Financial Reporting Standards (IFRS) and Inventory Valuation for Retail Companies

The emergence of IFRS (International Financial Reporting Standards) as a global accounting standard and its proposed phased adoption by the SEC has lent a sense of urgency to U.S. businesses trying to determine what impact the changes will have on them. Retail companies are especially concerned about what it might mean to inventory valuation, given that the system most commonly used today, Retail Inventory Method or RIM, is not completely compatible with IFRS. Companies might consider moving to a weighted average type of Cost Method Accounting (CMA) which does comply with IFRS requirements and offers other significant strategic benefits as well.

IFRS, the SEC and the Roadmap to the Future

IFRS is a set of accounting standards developed by the International Accounting Standards Board (IASB) for public companies around the globe. Companies based in the European Union countries have been required to use IFRS since 2005 and today about 12,000 companies in 113 countries have adopted this standard for financial reporting.

In November, 2008 the Securities and Exchange Commission (SEC) announced a proposed roadmap that would require public companies to file their financial reports using IFRS instead of the current standard, U.S. Generally Accepted Accounting Principles (GAAP). The roadmap lays out a phased transitional period as follows: Under a staged transition, IFRS filings would begin for large accelerated filers for fiscal years ending on or after Dec. 15, 2014. Remaining accelerated filers would begin IFRS filings for years ending on or after Dec. 15, 2015. Non-accelerated filers, including smaller reporting companies, would begin IFRS filings for years ending on or after Dec.15, 2016. In addition the SEC had proposed that some U.S. issuers with worldwide operations might elect to use IFRS as the basis for their financial reporting as soon as December, 2009.

Coinciding with the announcement, the SEC set up a 3 month public comments period to encourage and accommodate input about IFRS from U.S. companies and other interested parties. That period was extended another 3 months and officially closed in April, 2009. Commentary from the American Institute of Certified Public Accountants (AICPA) indicates that while much of the public input indicates support for high-quality, generally accepted global standards, there is much concern as well, usually relating to the cost and effort of transitioning from one standard to another and the suggested timetable. There are also concerns relating to specific industries. The SEC is expected to complete its review of the public comments and make a decision regarding the roadmap timetable by 2011 and also decide whether IFRS will be a mandated or recommended standard for U.S. companies.

For many retailers, a fundamental question for the SEC is whether the Retail Inventory Method (RIM) of accounting currently in use by many companies will be permitted under a new IFRS-based system. In its public comments letter to

the SEC, the National Retail Federation has expressed concern over the potential non-admissibility of RIM under IRFS and the ensuing cost and effort to remediate. While a final decision is yet to be made on this issue, it may make sense for retailers to consider converting to a Cost Method of Accounting (CMA) system, which is not only compatible with IFRS but can have other advantages over RIM as well.

Retail Inventory Method (RIM)

RIM was developed before computer systems were sophisticated enough to track perpetual inventory. It is a year-to-date system that tracks inventory valuation at an aggregated level, usually a class level. Under this method, the purchase costs are accumulated for the year-to-date period at the class level and the value of the merchandise acquired is determined at the retail price. The ratio of accumulated cost to the value at retail price is called the complement. The cost is not tracked at an item-location level. To derive the cost of sales, the retail value of the units sold is multiplied by the complement.

When the retail selling price changes, which often happens - especially with seasonal products, the value at retail price is recomputed for all the units on hand. A new cost is recomputed for the balance sheet by multiplying the value at retail by the complement. The difference between old cost and new cost is booked to Cost of Sales. This revaluation of inventory at the time of retail price change can cause significant divergence from the cost as defined by IFRS, one of the main reasons RIM may not be admissible under IFRS.

Cost Method of Accounting (CMA)

The cost method of inventory valuation works with modern accounting systems to track the unit inventory at the item-location level and track valuation at moving average cost. The moving average cost is computed every time a goods receipt occurs. All relief of inventory, including those for sales, happens at the moving average cost prevailing at the time of the relief. The inventory valuation reflected in the balance sheet is also at the moving average cost. This definition of cost is widely accepted under IFRS.

IFRS currently mandates that a business' saleable inventory should be recognized at cost. With the Cost Method of Accounting, inventory is stated at the lower of cost and net realizable value (ISA2.10 definition), which is similar in principle to lower of cost of market (LOCOM) under the current US GAAP system.

Cost encompasses costs of purchase, costs of conversion and other costs incurred in bringing items to their present location and condition (IAS2.10). Where individual items are not identifiable, the first in, first out (FIFO) or weighted average cost formula is used. Last in, first out (LIFO) is not acceptable (IAS2.25) under IFRS. Net realizable value is the estimated selling price less the costs to complete and costs to sell (IAS2.6).

Benefits and Challenge with CMA

Benefits:

- **Item-Location Profitability:** The move to cost method implicitly means that along with unit tracking, revenue and costs are tracked at the item-location level. This provides a powerful merchandise planning tool and allows for optimal assortment selection for limited shelf space. *This is the single most important reason for retailers to consider CMA.*

- **Easy to Understand Valuation:** Using CMA, true revenue less true costs provides gross margin. Under RIM, the revaluation due to retail price changes requires additional analysis by merchants as to what caused the shift in gross margin. While experienced merchants can navigate the analysis, it is not intuitive to new entrants and other business persons not versed in RIM.
- **Consistency Across the Business:** Many retailers have other businesses in addition to retail, like wholesale, direct to business, etc. where RIM is not usable or permissible. Similarly, many retailers often prefer to use CMA for cost inventory at their distribution centers while their stores are still using RIM. A move to CMA provides consistency of valuation throughout the business.
- **Compliant to Standards:** CMA conforms to IFRS. While an exception was issued for RIM under US GAAP there is currently no such exception provided under IFRS. Even if one is provided it may not be in perpetuity.

Challenge:

- **Treatment of Delayed Costs:** The cost method of accounting is built around moving average cost that is based on perpetual tracking of units. Computation logic for moving average requires that most of the procurement costs are available at the time of receipt. This does not always happen. So the delayed costs are not absorbed in the moving average cost because the goods have often moved from the distribution center to the stores or have been actually sold to customers.

While time is still on their side, retailers should evaluate their businesses to see whether CMA might be right for them.

Inventory Valuation Methods Supported by SAP

Over time SAP has enlarged and refined the way its Retail Industry Solution manages inventory accounting. The solution now supports a wide range of inventory accounting methods, from traditional year-to-date RIM, the extended retail method of accounting, and CMA, with or without retail tracking. This wide spectrum of capabilities provides retailers with options to suit their business and accounting requirements.

The methods supported by SAP can be categorized as:

Aligned to Cost Method of Accounting:

- Cost Only – This is the method invariably used by businesses outside retail, though some retail businesses have chosen to implement it as well. Under this method the cost is tracked as a perpetual moving average.
- Cost Plus Retail – With the increased sophistication of analytics in SAP BI at the item-location level, more and more retailers are seeing the value of this approach. It tracks the inventory at the prevailing retail and at cost using the perpetual moving average. *The combination of retail and cost tracking in real time provides a powerful tool to help merchants analyze the performance of individual products or product segments.*

Aligned to Retail Inventory Method:

- Extended Retail Method of Accounting (ERMA) – cost is tracked at perpetual moving average. Inventory at prevailing retail price is also tracked. Based on the retail price changes, markdowns are taken and cost booked to cost of

sales. Though this method includes writing down of cost at the time of markdown, it differs from RIM in the sense that ERMA is a perpetual method, while RIM is year to date (periodic).

- Retail Inventory Method – under this method SAP tracks the units and computes inventory valuation and cost of sales (very similar to the traditional Retail Inventory Method). Based on the computation, financial entries are created in the general ledger.

Regardless of the SAP inventory method chosen, the inventory units are tracked at the item-location level.

Item-Location Level Accounting

Proper analysis of loss leaders, winners and losers and the impact of promotions on actual gross margin are often hard to compute and at best are based on cost allocations that can be misleading. SAP provides tools that conduct analysis on the item-location level and make it possible for retailers to compare item profitability, for example, their own brands with third-party branded items, allowing for more meaningful space allocations and vendor negotiations.

The emergence of IFRS as the possible accounting standard for retail companies has opened the debate for a move to an item-location level inventory accounting method. But the decision to move to such a solution can be considered for a number of other reasons as well, including:

- Competitive advantage of moving to item-location accounting
- Integrated planning, execution and accounting solution
- Replacement for aging applications
- Consolidation of application footprint
- Move to a leading practice driven packages solution vs. in-house custom applications

Capgemini Experience

Capgemini has provided solutions to a wide range of retail companies. For example, Capgemini has worked with a large fashion retailer based in the U.S. to implement SAP retail solutions across different businesses. Besides merchandise planning and supply chain planning and execution, inventory valuation was a key component of the implementation - moving from the Retail Inventory Method to Cost Method of Accounting for inventory accounting. The key challenge was managing the transition from RIM to CMA and reporting consistently to the external stakeholders. An innovative approach made for a smooth overall implementation.

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