otto group

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Mitglied des Vorstandes

Sir David Tweedie
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Dear Sir David

Re.: Exposure Draft of Proposed Improvements to International Financial Reporting Standards – Proposed Amendments to IAS 38 Intangible Assets: Advertising and promotional activities

About the Otto Group

Otto is the world's leading mail-order group: Still privately owned, the Otto Group is trading and providing services in all important markets in Europe, North America and Asia. In addition to trading both in retail and wholesale, the Otto Group is selling a broad range of trading-related services such as logistics and financial services. The Otto Group's 55,100 employees work in 123 major companies operating in 19 countries. In 2006/07 the Otto Group generated revenues of 15.2 bn EUR in four strategic segments: Multi-channel retail (9.2 bn EUR), financial services (1.4 bn EUR), services (0.6 bn EUR) and wholesale (4.0 bn EUR). Starting its business in the domestic market in 1949, the Otto Group has increased its foreign revenues up to 54% in FY 2006/07.

We appreciate the opportunity to respond to the exposure draft entitled *Proposed Improvements to International Financial Reporting Standards – Proposed Amendments to IAS 38 Intangible Assets: Advertising and promotional activities.*

Overview

In general, we welcome the Board's attempt to clarify accounting requirements and to remove areas of inconsistency in practice. We agree that the proposed amendments clarify the treatment of expenses in cases where no intangible asset or other asset is acquired or created that can be recognised. In those specific cases, where expenditure forms no part of the cost of an intangible asset and is expensed as incurred the amended wording of paragraph 69 of IAS 38 helps to resolve the divergent interpretations which have developed about when such expenses are incurred.

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However, we strongly believe that IAS 38.69 should not be used to determine whether an entity may recognise as an asset goods or services that might be used for advertising. We find that applying the principle proposed regarding expenditure on advertising and promotional materials on such items as catalogues would appear to be at odds with the basic definition of an asset. We continue to believe that catalogues in the mail-order business should not be considered as just a form of advertising or promotional material, but meet the requirements for the recognition of an intangible asset. An asset that needs to be capitalised and amortised over its life cycle in order to fairly present the financial statements of a mail-order company by making them comparable with the financial statements of other type of retailers.

Due to the substantially different character and purpose of catalogues in comparison to general advertising activities and untargeted promotional materials it does not appear to us to be appropriate to simply subsume them as an item of advertising material. Consequently, IAS 38.69 including the proposed amendments is, in our view, not relevant for the treatment of catalogue costs since catalogues are not considered part of the advertising or promotional items of mail-order companies. We believe that the recognition of catalogue costs as an intangible asset is in accordance with IFRS and in doing so provides appropriate information to the users of the financial statements for their economic decisions.

In this context we would like to explain the business model of mail-order companies such as the Otto Group.

Business Model

Mail-order companies form a specialised group of retailers within the retail market. Whereas a conventional or a web-based retailer offers its range of products directly to the customers in a shop or department store or on its web site, respectively, the mail-order company presents its merchandise via catalogues. As much as stores or web sites are the core sales media - the points of sale - for the conventional retailer and the web-based retailer, the catalogues are the heart of the mail-order business. Neither type of retailer would be able to generate any sales without his core sales medium.

Sales in mail-order business are generated by a large variety of different catalogues. The main catalogues, the „big books“, feature the standard assortment on some 1,200 pages. Specialised catalogues are issued for specific brands or for specific product lines or even for specific customer groups and have up to 500 pages. The life cycle depends on the character of the catalogues: Whereas fashion brands are issued every 6 months or even more frequently, some catalogues, e.g. furniture catalogues, are only issued once a year. Generally, a longer life cycle is not economically feasible due to changes in fashion styles, in technological developments and in price dynamics.

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Store design and product range as well as servicing the customer while in the shop are the outflow of the specialised trading know-how of a store-based retailer. Economic success is controlled on a single shop basis: Sales and costs are directly allocated to each shop; key-operating figure is sales per square metre. For the mail-order business, catalogues serve as the point of sale. They are the main interface to the customers, representing an entire department store at home and providing the shopping experience of high street. Each year, the numerous innovative catalogue concepts respond quickly to changing trends. The shopping experience takes place in a comfortable atmosphere without any rush, no restrictive opening hours and merchandise delivered as desired in a variety of options. Thus catalogues are the convenience store at the customers' home. They present the complete assortment of the mail-order company and are the basis of orders, revenues and cash flows.

In order to thoroughly understand the role of catalogues in the mail-order business it is necessary to look deeper into the business model itself and the four major steps of the 'competence chain':

Catalogue creation includes continuous improvement of the main catalogue's features, some 500,000 different items on more than 1,000 pages. Mail-order companies put a strong focus on customer added value as well as on in-depth customer, product and market analyses. Strict controlling of a catalogue's sales and efficiency leads to highly reliable sales forecast models and sophisticated determination of any specific catalogue run date (point of time for the initiation of a catalogue). Catalogues are protected by copyrights. Furthermore, due to the exclusiveness of some of the merchandise range and specific article numbers used, catalogue offers can only be ordered at the offering mail-order company.
Careful consideration is given to the *catalogue distribution*. The „expected revenue per catalogue" is identified for each customer on the basis of buying and payment histories as well as the sociological and socio-demographical characteristics of the customers. Additionally, customer ranking according to customers' past sales is taken into account. Clearly defined, statistically proven forecasts of future buying patterns guarantee a best-fit catalogue circulation. Perfect catalogue distribution is determined by the revenue contribution of a customer tier meeting exactly the contribution margin necessary for positive results. All these methods ensure that catalogues are not distributed randomly, but directed to selected customers only. The number of catalogues is defined by the contribution margin of the last catalogue distributed, covering its costs. As much as location and trading area are key factors for the economic success of a store-based retailer, address scoring and customer selection are vital for the mail-order business.

The sophisticated *order process* focuses strongly on customer added value. It comprises various order possibilities, 24hours/7days a week availability, highly personalised support and immediate delivery information. Stored customer data enables quick order processes and various delivery options and services are offered.

The use of catalogue-specific article numbers ensures a clear *assignment of revenue* to a certain catalogue. An article can only be ordered via that specific number at the offering mail-order company. Sales are generated over the whole life cycle of a catalogue and economic success is measured by sales per circulated page.

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Catalogues vs. advertising and promotional activities

As a store at home, a catalogue is neither general advertising nor promotional material. Catalogues are the central medium for generating sales and cash flows, they form the key element of the mail-order business model. Therefore, catalogue creation and distribution are not mere processes to support sales – they are the indispensable pre-condition for mail-order sales and represent the key competence of a mail-order company.

The catalogue and its brand itself is advertised and promoted in order to increase the customer base by using a variety of advertising and promotional activities: Non-address based advertising like flyers with limited offers including order forms, bulk mailings and enclosures in magazines. Address based advertising through mailings offering the catalogue itself, if desired, and so called 'acquisition' flyers to addresses rented are used to elicit sales. Furthermore, traditional advertising is placed using print media, TV and radio spots as well as mailed newsletters. All those general advertising and promotional activities might also be outsourced as they are not part of the core competence of a mail-order company. They are just assisting means to increase sales by promoting the catalogue as the virtual store of the mail-order company and forming its brand image. Additionally, they focus on certain articles out of the complete range of products offered by the mail-order company in order to especially advertise those. The Otto Group expenses such advertising and promotional activities as incurred since these activities form largely untargeted information and usually enfold only a short-time impact resulting in future economic benefits being not reliably measurable.

Catalogue costs cover all expenditure incurred by the mail-order company to enable it to offer its customers the catalogue with the featured product range. The measurability of costs as well as their assignment to specific catalogues is ensured by highly sophisticated systems and processes. Major cost components of a big book typically relate to content (approx. 15%); paper and printing (approx. 45%) and shipping (approx. 40%). Expenditure on catalogues amounts to 12-25% of sales of a mail-order company with no corresponding cost-line in the store-based or web-based retail business.

Due to their substantially different character and purpose catalogues can not simply be subsumed under advertising and promotional activities. They are used in the same way as high-street stores and operate as a distribution channel. In the mail-order business model catalogues costs represent investments in the 'department store at home'. Consequently, they are capitalised and amortised over the sales generating life-time of the specific catalogues. Against the background of the mail-order business' nature it would be inappropriate to just equate catalogue costs to general advertising and untargeted promotional activities. In our view, IAS 38.69 is therefore not applicable to catalogues costs.

That catalogues disserve a differentiated accounting treatment is a view also shared by US GAAP, which uses the same general rules for the definition and recognition of an asset as stipulated in the "Framework for Preparation and Presentation of Financial Statements". SOP 93-7 explicitly states that costs of direct-response marketing whose primary focus is to elicit sales – like catalogues – are recognised as an asset, if it can be proven that customers have responded specifically to the sales medium and probable future economic benefits will be generated. Those clearly assigned costs are capitalised and amortised over the estimated period of their benefits.

Accounting treatment/consequences

Mail-order companies capitalise catalogue costs due to the rationale that costs incurred represent an asset in terms of F.49 (a) *Framework for the Preparation and Presentation of Financial Statements*, which describes an asset as a "resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity". Furthermore, the additional requirements of F.83, i.e. "it is probable that any future economic benefit associated with the item will flow to or from the entity" and "the item has a cost or value that can be measured with reliability", are satisfied. Due to its nature the asset meets the definition of an intangible asset.

Although catalogues possess a physical substance (i.e. the paper they are printed on) this physical element is secondary to their intangible component because the physical substance only forms the supporting medium. As a store at home, a catalogue provides the platform to place a mail-order company's range of merchandise. Only the catalogues allow an interaction between the company and its customers. For both the customer and the mail-order company, the embodied information (range of products) is the primary focus and eventually determines the catalogues' *intangible* character (IAS 38.4).

Following the determination of the catalogues' predominantly character as intangible, IAS 38 *Intangible assets* is relevant for the appropriate accounting treatment of catalogue costs. Other standards especially IAS 2 are not applicable because catalogues which are not sold to customers do not meet the definition of inventories. Catalogues are neither held for sale in the ordinary course of business nor consumed in the production process.

Catalogues are *identifiable* (IAS 38.11) as they can be separated from the company as a whole, i.e. they can be sold, rented, licensed or assigned to others. The mail-order company has also the intellectual property right over its catalogues. It is possible to sell to a competitor the right to obtain future cash flows generated by customers placing orders regarding the products displayed in a certain catalogue.

Even after distribution to the customer, catalogues are a resource within the company's scope of *control* (IAS 38.13) because it is guaranteed that only the issuing mail-order company is able to obtain the future economic benefits. Even though the mail-order company loses the physical control over the distributed catalogues it maintains the all important control on the future economic benefits resulting from the department store at home (as represented by the entirety of catalogues) which is the relevant intangible component of catalogues. The mail-order company is de facto able to exclude third parties from the resulting cash flows of that specific catalogue's offer. Only the company that issued the catalogue is able to provide the customer the opportunity to order the displayed products (exclusivity of product range) and has therefore control over the future economic benefits generated by the catalogues.

This rationale is further supported by the similarity of catalogues and web sites as a sales medium. Web sites are recognised as intangible assets, if in addition to complying with the general requirements of IAS 38.21 it can be demonstrated that future economic benefits will be generated (IAS 38.57). Capitalisation is permitted in the case of a web site, if it is capable of generating revenues, including direct revenues from enabling orders to be placed. As orders placed through catalogues are closely traced by mail-order companies in order to monitor the effectiveness of the catalogues, the generation of future economic benefits is given. The use of catalogue-specific article numbers ensures a clear assignment of revenue to the catalogue which generated the sales.

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Catalogues represent an intangible asset that results from past events and is highly likely to provide *future economic benefits* to the mail-order company. As a result of the above explained 'competence chain' of mail-order companies and statistical data available the benefit generated in terms of future cash flows can be forecasted precisely. Additionally, highly reliable data about the customers' payment behaviour is available. The mail-order company is based on sophisticated cost controlling systems also capable to *reliably measure the costs* incurred to create the intangible asset.

As their core competence, mail-order companies create and distribute catalogues – the virtual department store at home. Therefore, they are technical feasible of completing this intangible asset. As it represents the main sales medium of a mail-order company the intention to complete and to use the catalogues as well as the ability to do so is naturally given. As demonstrated in the aforesaid the intangible asset will generate probable future economic benefits, costs attributable to the intangible asset are reliably measurable and adequate technical, financial and other resources to complete the development and enable the utilization of the asset are also available to mail-order companies. Hence, the additional requirements for internally generate intangible assets of IAS 38.57 are all met.

Since catalogues are not advertising or promotional materials and because they meet the definition as well as recognition criteria of an intangible asset it is appropriate and consistent to capitalise them and amortise them over their useful economic lives. The proposed amendments to IAS 38.69 do not change this fundamental assessment. In our view IAS 38.69 is still not relevant to catalogue costs since they do not present advertising and promotional items.

Furthermore, the proposed amendment does not appear to be consistent with a fair presentation of the financial position and financial performance of mail-order companies. Focusing merely on the moment of disposability of catalogues gives scope to accounting policies regarding the timing of expenses. By steering the access date of catalogues by a few days around the balance sheet date, mail-order companies would be able to allocate significant expenditure – the catalogue costs - to the desired accounting period and change considerably their financial performance of a period. Consequently, this would diminish the informational function of financial statements and reduce the comparability of different accounting periods on an annual or quarterly basis.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter and invite you to have a "Field Visit" at the Otto Group to get to know our business in detail.

Yours sincerely

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Member of the Executive Board and CFO

ppa Ludwig Richter
Vice President Group Accounting