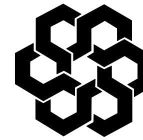

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This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

Project: **Identifying cash-generating units in the retail industry (Agenda Paper 14(iii))**

Issue

1. The IFRIC was asked to provide guidance on identifying cash-generating units (CGUs) in the retail industry.

2. The submitter sets out in its submission the typical fact patterns of the way the retail industry is organised (see the submission in appendix 2 for detailed features).

3. The submitter believes that there is diversity in practice on identifying cash-generating units in this industry. Some retail companies define a CGU as a single store arguing that each store has a different customer base and point to Illustrative Example 1A of IAS 36 *Impairment of Assets*. Others define a CGU as a whole chain arguing that cash inflows are not independent on a single store basis and that pricing, combined with other factors, is the significant driver to generate cash inflows.

4. The staff is aware that among major retail companies, some consider each hypermarket to be a CGU, whereas the CGUs for supermarkets cover geographical areas.

5. The issue is whether guidance on identifying CGUs is needed for this specific industry.

Staff analysis

6. IAS 36 states in paragraph 68 (emphasis added):

   As defined in paragraph 6, an asset's cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.

7. Paragraph 69 of IAS 36 then provides guidance on identifying whether cash inflows are independent:

   Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations. Illustrative Example 1 gives examples of identification of a cash-generating unit.

8. The Illustrative Example 1.A specifically deals with this issue. This example gives more emphasis to the fact that M's stores are in different neighbourhoods and probably have different customer bases than to the fact that pricing, marketing, advertising and human resources policies are decided by M.

9. The analysis concludes at paragraph IE 3 that *"although X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. Therefore, it is likely that X is a cash-generating unit."* (see appendix 3).

10. The staff notes that the above extracts from IAS 36 underline the point that it is the existence of independent cash inflows more than anything else that identifies a CGU.

Staff recommendation

11. The staff believes that it would be damaging to the principles based approach taken in IAS 36 for the IFRIC to elaborate on the guidance already given in that standard and therefore recommend the IFRIC not to take this item onto its agenda.

Do you agree with the staff recommendation and the wording for rejection set out in appendix 1?

Appendix 1: proposed wording for tentative agenda decision

[Deleted from observer notes]

Appendix 2: submission

The issue:

How does a Company identify a cash-generating unit in a retail chain store when cash inflows are identifiable but independence of the cash inflows is challenged?

Fact Pattern:

In the retail industry it is current practice that retail stores in one region are operated in integrated chains. The number of retail stores organised in such a chain can vary from below 20 to over 4.000. The region is defined in various ways, e.g. as a city, a geographic part of a country (district or county) or a country. An integrated chain may be characterised by several or all of the following features:

1. All stores have identifiable cash inflows as the goods are paid by the customer before leaving the store.
2. All supply contracts incl. negotiations on volume rebates and general marketing allowances, logistic contracts, marketing and advertising as well as employment contracts and remuneration for employees are processed and agreed upon centrally through the ultimate group or company management.
3. Pricing, range of product and services, set-up of stores, location of stores, investment and disposal decisions as well as marketing and advertising activities made by ultimate group or company management only.
4. The store manager and/or other employees are generally not remunerated based on store profitability. Key performance indicators include e.g. theft rate, cleanliness of the store, friendliness of employees and alike and represent key drivers for bonus payments.
5. All stores are operated in a uniform way under one corporate identity theme or brand.
6. Customer bonus, rebate or loyalty programs exist as homogenous group program for all stores (i.e. rewards can be earned in any store irrespective of its location and can be redeemed alike in any store of the chain).
7. For management purposes only the group view of the highly integrated and centralized business is applied to use the advantages of economies of scale (purchase power) especially in supply and logistics contracts

Current practice:

Current IFRS application practice is diversified. Some would consider a retail chain that is characterised by the above features as one cash-generating unit while others consider the individual store as a single cash-generating unit. The fact pattern is based on a retail store chain but the issue might not be limited to the retail industry.

<u>Reasons for the IFRIC to address the issue:</u>

IAS 36.6 defines *"a cash-generating unit as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets."* There seems to be unclear guidance in IAS 36 when cash inflows are not independent even though they are identifiable. Moreover, current practice is diverse, leading to significant differences in the timing the impairment loss recognition, the amount of the impairment loss to be recognised and the recognition of additional liabilities required by other Standards if an amount remains after the impairment loss allocation following IAS 36.104 and 105. The views expressed below should be read as examples and merely to illustrate why an IFRIC interpretation is needed and appropriate. There may be others, defending still other methods of accounting and there may be those who would defend any of the views mentioned below, but for different reasons.

View 1

Those who would argue that impairment should be tested for with reference to single stores argue that each store generates own cash inflows based on a customer base which is at least to a large extent specific to the individual store. Paragraph 6 of IAS 36 stresses cash inflow and does not take net cash flows into consideration when identifying a cash-generating unit. Also proponents point to Example 1A in the Illustrative Examples in IAS 36 (identification of a cash-generating unit in a retail store chain). The example concludes for a similar fact pattern that the single store likely serves as cash-generating unit.

Also proponents of the single store view argue that financial data are available on a single store basis and will de facto to some extend trigger disposal or closure decisions.

View 2

Those who would argue that impairment should be tested on the network of different stores (i.e. the retail chain) argue that the cash inflows are not independent on a single store basis. They argue that pricing is the significant driver to generate cash inflow as pricing combined with loyalty programs creates a single customer base and these customers would decide to buy at a specific chain as opposed to a specific store. Thus cash inflows are dedicated to the chain.

In addition, proponents of this view state *"that the identification of an asset's cash-generating unit involves judgment"* under IAS 36.68. Further IAS 36.69 makes clear *"in identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or group of assets), an entity considers various factors including how management monitors the entity's operations or how management makes decisions about continuing or disposing of the entity's assets and operations"*.

Finally, proponents of this view challenge the applicability of Example 1A in IAS 36 as the example:

(a) assumes an internal management reporting on a store-by-store basis also measuring the performance on this level;

(b) concludes that customer bases of the different stores are probably different; and

(c) excludes any interdependencies between the cash inflows of different stores operated as an integrated chain.

Appendix 3: Illustrative Example 1A accompanying IAS 36

A - Retail store chain

Background

IE1 Store X belongs to a retail store chain M. X makes all its retail purchases through M's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring X's cashiers and sales staff) are decided by M. M also owns five other stores in the same city as X (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as X. X and four other stores were purchased five years ago and goodwill was recognised.

What is the cash-generating unit for X (X's cash-generating unit)?

Analysis

IE2 In identifying X's cash-generating unit, an entity considers whether, for example:

(a) internal management reporting is organised to measure performance on a store-by-store basis; and

(b) the business is run on a store-by-store profit basis or on a region/city basis.

IE3 All M's stores are in different neighbourhoods and probably have different customer bases. So, although X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. Therefore, it is likely that X is a cash-generating unit.

IE4 If X's cash-generating unit represents the lowest level within M at which the goodwill is monitored for internal management purposes, M applies to that cash-generating unit the impairment test described in paragraph 90 of IAS 36. If information about the carrying amount of goodwill is not available and monitored for internal management purposes at the level of X's cash-generating unit, M applies to that cash-generating unit the impairment test described in paragraph 88 of IAS 36.