Accounting Topics in the Retail Industry

An Honors Thesis (HONR 499)

by

Sarah Stichter

Thesis Advisor
Dr. James Schmutte

Ball State University
Muncie, Indiana

April 2015

Expected Date of Graduation

May 2015
Abstract

Financial statements are only valuable to investors and creditors if they are prepared in a relatively similar way so as to be able to be analyzed and compared. The Financial Accounting Standards Board (FASB) continually evaluates and updates its accounting standards to keep up with changing times and areas of significance. The FASB issues the standards that companies must follow when accounting for transactions and preparing their financial statements. The standards affect different industries in specific ways. I describe current and proposed accounting treatment for financial reporting issues that are commonplace in the retail industry and how they affect retailers' financial statements.
Acknowledgements

I would like to thank Dr. James Schmutte for encouraging me to think outside the box and to dig a little bit deeper in my research. I would also like to thank my family for encouraging me through this process.
Accounting Topics in the Retail Industry

According to Barbara Farfan, an expert in the retail industry, about two-thirds of the U.S. gross domestic product comes from shopping at retail stores. In 2011, total retail sales equaled $4.7 trillion (Farfan, 2014). The retail industry is an essential part of the economy and is a good indicator of how well the economy is performing. Retailers buy large quantities of goods from manufacturers or wholesalers and sell the goods in smaller quantities to end users. End users are consumers who use the goods, not people who are going to resell the goods (Farfan, 2014).

The retail industry can be broken down into multiple categories. One way to distinguish between retailers is the type of goods they sell. The two main categories of goods are hard goods and soft goods. Hard goods include furniture, electronics, appliances, and sporting goods (“The Industry,” 2014). Stores that sell hard goods include Pier 1 Imports and Best Buy. The other category of goods, soft goods, includes clothing and apparel (“The Industry,” 2014). Stores that sell soft goods include Macy’s and JCPenney. The majority of retailers sell a combination of both hard and soft goods.

Another way to categorize retailers is by the type of store. Department stores are the most popular type of stores. These are large stores that offer a wide variety of goods (“The Industry,” 2014). Department stores focus on quality over price, so many of these stores offer higher priced goods. Bloomingdale’s is a good example of a high-end department store. The second popular store category is a discount store. Discount stores also offer a wide variety of goods, but they focus more on price, so goods are less expensive at discount stores (“The Industry,” 2014). Walmart is an example of a popular discount store. The last main category of store is a specialty
These stores are retailers that focus on a specific type of goods. Each category of store has a different focus and a different strategy for success.

There is also segmentation within each of the three types of stores. Some stores are more upscale with higher quality goods and also higher prices, while other stores may have goods of lower quality or lower prices. For example, within department stores, Neman Marcus is an upscale store compared to Kohl’s or JCPenney, which are more affordable to the general public. Within discount stores, there is a distinct difference between Target and Wal-Mart. Wal-Mart is considered a lower cost store, while Target is known for higher quality merchandise. Even specialty stores have segmentation. They can be large, multinational brands or smaller “mom-and-pop” shops. For example, Victoria’s Secret is a specialty shop that focuses on women’s undergarments, but it is large and operates multinationally. Smaller shops are specialty stores because they cannot afford to offer more products to stay profitable. Smaller stores often have a different and more personal atmosphere compared to the larger chains that often dominate the market.

Whether a retailer runs a discount or department store or sells hard or soft goods, the retailer needs investors and creditors to finance the business and help the business be successful. Investors and creditors want to make sure the company is one that is going to be successful and a good steward of their money. They look at a company’s financial statements to consider whether the company is one that will provide a return on their investment. The financial statements include a balance sheet, income statement, statement of shareholders’ equity, and statement of cash flows.
Investors and creditors can gather a variety of information from the financial statements of a company. The balance sheet shows a company's assets, liabilities, and equity at a point in time. From the balance sheet, investors and creditors can assess the liquidity, solvency, and financial flexibility of the company. The income statement shows the success of a company's operations for a certain time period. The income statement contains revenues and expenses recognized during the period. From the income statement, investors and creditors can evaluate the performance of the company and predict future performance. The statement of shareholder's equity details the change in retained earnings and other equity accounts for a period. The statement shows each account individually and any additions or deductions. Additions could include the sale of additional stock or net income. Deductions could include the repurchase of stock or dividends. Lastly, the statement of cash flows, one of the most important financial statements, details the inflows and outflows of cash during a period (Kieso, 2012). None of the other financial statements focus on actual movements of cash. The statement of cash flows shows investors and creditors whether the company is generating enough cash to be successful.

The financial statements are the main resources that investors and creditors use to gather information about companies, so it is extremely important that the information be relevant, reliable, consistent, and objective.

In the United States, the preparation of financial statements and accounting principles are governed by several governmental and nongovernmental entities. The three organizations that helped develop the financial accounting standards in the United States are the Securities and Exchange Commission (SEC), the American Institute of Certified Public Accountants (AICPA), and the Financial Accounting Standards Board (FASB). These three organizations have created generally accepted accounting principles (GAAP). The SEC requires that publicly traded
companies follow GAAP and the AICPA requires that financial statements be in accordance with GAAP for auditors to issue unqualified opinions. Public companies are also required to follow any additional guidelines set out by the Securities and Exchange Commission (SEC). Private companies are not held to as stringent a set of standards; however, most creditors require that private companies follow GAAP. Due to the enormity of the amount of standards and the various formats of the standards, the FASB created the FASB Accounting Standards Codification (ASC), which was created for easier user access to GAAP standards (Kieso, 2012). The ASC is available for anyone to use and is the main authoritative GAAP guidance set up by the FASB for publicly traded and privately held companies.

Even with a set of unified standards, there are a variety of choices the company needs to make in the application of GAAP to prepare the financial statements. These choices affect the financial statements and how an investor interprets them; so it is important for investors to understand the accounting principles used within the financial statements. For the retail industry, like any other industry, there are a variety of accounting issues that are commonplace in the industry. The topics covered in the paper include: how to account for inventory, how to treat leases on the financial statements, how to account for various forms of advertising, how to account for the value of a brand, how to account for the sale of gift cards, and how to account for a customer rewards program. The guidance for these issues comes from GAAP. These issues are important for a user because they make a difference in how the company is represented through the required financial statements.

The first topic deals with the largest asset account for retailers: inventory. An account is the financial record of a company’s assets, liabilities, or equity. Inventory is especially important to retail companies. According to the ASC, inventory for a retailer includes all tangible personal
property that is held for sale in the normal course of business (ASC 330-10-20). Because retailers do not manufacture their goods, inventory does not include raw materials, supplies, or work-in-process goods. When a retailer originally purchases merchandise, it records the purchase at cost, which is the price paid or consideration given to acquire the inventory. Even recording the cost of inventory is not a straightforward calculation. A company needs to decide what goods to include in inventory and the various costs to include in inventory. For example, a company needs to decide when ownership transfers for goods still in transit at the end of a period. The seller can choose the terms of the sale, i.e., free on board (f.o.b.) destination or f.o.b. shipping point. F.o.b. shipping point means that ownership of the goods transfers when the supplier delivers the goods to the carrier who will transport the goods. The costs of goods in transit purchased under f.o.b. shipping point are counted in inventory for the purchasing company. On the other hand, f.o.b. destination means that ownership does not transfer until the goods are delivered to the buyer. The cost of goods still in transit under f.o.b. destination is not included in the buyer’s inventory (Kieso, 2012). The opposite can be said if the retailer is the seller. The cost of goods which are still in transit under f.o.b. shipping point are not counted as the seller’s inventory, and the cost of goods in transit under f.o.b. destination are counted in the seller’s inventory.

In addition to the issue of transfer of goods, a company needs to decide what costs are included as inventory. There is more included in the inventory account than just the cost of the physical goods. Costs that are inherently connected with the inventory are also included in the inventory account. These costs are called product costs. Product costs can be directly tied to the products a company is selling. They can include freight charges on goods purchased, direct costs of acquisition, and labor and production costs to bring the goods to a ready-to-sell condition. Costs that are indirectly related to inventory are called period costs and are not included in the
inventory account. Period costs can include selling expenses, general expenses, and administrative expenses. Determining between product and period costs is not an easy process, so each company needs to set up individual procedures determining what costs are included in the inventory account (Kieso, 2012).

Due to the number of costs which are included in the inventory account and due to the volume of inventory that runs through large retailers' stores, it is costly to keep track of the historical cost of each piece of inventory; therefore, companies choose from a variety of methods to value inventory at the end of a reporting period. Most often, companies are unable to track the physical flow of goods in and out of the store. Items sold within the store are interchangeable and the company does not track which exact items are sold. In order to be able to calculate inventory and the cost of goods sold, most companies use a cost flow method. A cost flow method estimates the cost of inventory at period end based on the cost of beginning inventory and the purchase costs of incoming inventory. Cost flow is much easier for retailers to track than physical units but does not provide as accurate a result.

The ASC details four main methods to account for the ending inventory balance: specific identification, weighted average cost method, first-in-first-out (FIFO) method, and last-in-first-out (LIFO) method (ASC 330-10-30-9). Specific identification requires keeping track of each piece of inventory individually in regards to when it was sold and its historical cost. Specific identification is usually used by companies selling larger, more unique items, such as cars. The weighted average cost method takes an average of all goods in inventory at any certain time to calculate the ending inventory balance and the cost of goods sold for the period. Weighted average cost method is often used when inventories cannot be differentiated from one another. This could be the case for chemicals that are mixed together regardless of date of purchase. The
FIFO method requires that the cost of the beginning inventory and goods purchased first are assigned to cost of goods sold first. FIFO is useful for the food goods industry where the first goods purchased are likely to be sold first. The LIFO method requires that the cost of inventory most recently purchased be assigned to cost of goods sold first. The ending balance of inventory is based on the cost of the beginning inventory and the goods first purchased. LIFO is used widely throughout the United States, even though it does not accurately reflect the physical cost of goods remaining in inventory. The goods sold are assumed to be the first bought, so they would be priced at a lower cost. LIFO is the most used inventory valuation method because it reduces net income for the period, which reduces income taxes for the company. If a company chooses to use LIFO for tax purposes, it must also use LIFO for financial reporting (Kieso, 2012). It is important for a company to choose the best method for its business because the method of accounting for inventory determines the cost of goods sold for the period, which ultimately affects net income for the period. A company wants to look for an inventory valuation method that provides a good match between costs and revenues.

These four costing methods are not the only options for a company. Retail companies often use a different type of costing method than the four previously discussed due to the high volume of merchandise of varying types that move through each store. The retail method can approximate the different cost flow assumptions discussed based on the way the cost-to-retail ratio is calculated. The retail method requires the company to track its inventory based on retail prices. The retailer then uses a formula to convert retail prices to cost. To calculate the retail method, the company starts with the beginning inventory for the period at retail prices and adds any purchases made during the period. Then, the company deducts the sales made during the period. The company also adjusts the account for any discounts, returns, spoilage, or shrinkage.
that occurred during the period. The retail method also takes into account any markups or markdowns of inventory. Markups are an increase in the original selling price; Markdowns are decreases in the original selling price (Kieso, 2012). The ending inventory is then multiplied by a cost-to-retail ratio that is calculated each period. The ratio is calculated by taking the cost of total goods available for sale at cost, which is calculated depending on the cost flow method being used, divided by the total goods available for sale at retail prices. Cost of goods available for sale is calculated by taking the beginning inventory and adding any purchases for the period. The retail method requires a company to track inventory at both cost and retail methods (Kieso, 2012). In the case of Macy's department stores, Macy's separates its merchandise into different departments, and each department has its own cost-to-retail ratio used to calculate the ending inventory value. Macy's uses an even more complex form of the retail method called the LIFO retail method (Macy's Inc., 2014). With the LIFO retail method, the beginning inventory is excluded from the cost-to-retail percentage.

If retailers are unable to use the retail method, they can use an alternative method to estimate ending inventory and cost of goods sold. The gross profit method uses the historical gross profit ratio of the business to estimate the value of the ending inventory. First, the company calculates cost of goods available for sale. Next, it calculates the gross profit ratio, which is gross profit divided by sales. Then, the company multiplies the gross profit ratio by sales made during the period to estimate the gross profit in dollars. Lastly, the company subtracts the gross profit from total sales and subtracts the difference from cost of goods available for sale. The calculation estimates ending inventory (Kieso, 2012). The gross profit method assumes that the gross profit for the company stays stable throughout the period, which may not be accurate for retailers whose sales seem to peak at seasonal times.
After identifying the correct costing method for inventory, a retailer still has work to do with the inventory account. Inventory can often lose value over time, and it is important to not overstate the value of inventory. Just as companies use impairment tests to value some assets, retail companies can use the lower-of-cost-or-market method. Companies value goods at cost or cost to replace, whichever is lower. A company can never write inventory up if it increases in value, but if inventory loses value, a company needs to restate the cost at the cost to replace in order to not overstate the inventory balance. The lower-of-cost-or-market method follows the conservatism principle of the accounting framework. It is important to note that conservatism does not mean a deliberate understatement of accounts, which may account for higher income in later periods. Conservatism means that when faced with multiple choices on how to value an account, a company should choose the method that produces the least amount of net income. The lower-of-cost-or-market method enables companies to follow the conservatism principle with a set standard (Kieso, 2012). Macy’s department store applies the lower-of-cost-or-market principle along with the LIFO retail inventory method when valuing its inventory account (Macy’s Inc., 2014).

Due to the many options to use when valuing inventory, it is important for a company to disclose what method it is using. Macy’s has a note to the financial statements which details the exact method used in valuing inventory. The note also explains when physical inventory counts are taken, as well as any management judgments and estimates which are used in valuing the inventory (Macy’s Inc., 2014). The way a company chooses to value its inventory has an effect on the company’s financial statements. For example, if a company uses the FIFO method to value inventory, its inventory account will have a higher value causing current assets in total to have a higher value as compared to LIFO. Also, the use of FIFO causes net income to be higher.
due to the decrease in cost of goods sold based on the ending inventory balance. On the other hand, the use of the LIFO method has the opposite effect. Current assets are lower than FIFO because the cost of the oldest inventory is left in the account, and the increase in cost of goods sold causes net income to be lower (Kieso, 2012). Any of the inventory valuation methods detailed above is acceptable according to the ASC, but a company needs to decide which method best reflects the flow of costs in its business and provide a reasonable value for ending inventory.

Inventory may be arguably the most important issue for retailers, but leases can be an especially difficult topic. When retailers operate brick-and-mortar stores, they can either buy the buildings, or they can lease the buildings. If a company buys the building, the accounting is relatively straightforward. They would recognize an asset on the balance sheet and credit cash or a liability account when they purchase the building. They then recognize the applicable depreciation for the asset over its life. When a company leases a building instead of buying it, the accounting treatment is different. The lessee either records rental expenses or treats the leased property as if it was purchased. There are many advantages to leasing buildings instead of buying them. These advantages include 100% financing at fixed rates, protection against obsolescence, flexibility, less costly financing, and tax advantages (Kieso, 2012). These advantages make leases look very attractive to retailers.

Under the current FASB standards, leases are considered either capital leases or operating leases. A capital lease is similar to an installment purchase. The company accounts for the building as if it was purchased, and the rental payments are accounted for as debt service. An operating lease is similar to a rental agreement. The landlord is allowing the business to use the building for a certain fee, but the landlord maintains ownership of the building. The FASB has four criteria detailed in the ASC to determine whether a lease is to be accounted for as a capital
or operating lease. If the lease meets at least one of the four criteria, the company must capitalize the lease. If the lease meets none of the criteria, the lease is an operating lease.

The first criterion is a transfer of ownership. If the lease transfers ownership of the asset to the lessee at the end of the lease, the lease must be capitalized. Transfer of ownership is the easiest of the four criteria to evaluate. The second criterion is if the agreement includes a bargain purchase option. A bargain-purchase option gives the lessee the option to purchase the asset at the end of the lease at a price significantly lower than the fair value of the asset at the date the option is exercisable. The difference between the option price and the expected fair value must be large enough to assume the lessee exercise of the option. If the lease contains a bargain-purchase option, the lease must be capitalized (Kieso, 2012). The third criterion is based on the economic life of the asset. If the life of the lease is greater than or equal to 75% of the economic life of the asset, the lease must be capitalized. The last criterion is based on a recovery of the investment. If the present value of the minimum lease payments is greater than or equal to 90% of the fair value of the asset, then the lease must be capitalized. The minimum lease payments of the lease include the minimum rental payments, guaranteed residual values, penalties for failure to renew or extend the lease, and any bargain-purchase option. Any executory costs should be excluded from the minimum lease payments. Property taxes and insurance costs are examples of executor costs. The minimum lease payments are then discounted to present value using the lessee’s incremental borrowing rate (Kieso, 2012).

Whether the lease is capitalized or not impacts the company’s financial statements. When a lease is capitalized, the lessee recognizes an asset and a liability equal to the present value of the rental payments. This affects various financial ratios calculated from the balance sheet accounts, including the debt to equity ratio. A leased asset increases total assets while also
increasing total liabilities. The company depreciates the asset over its economic life and incurs interest expense over the life of the lease. If the lease is not capitalized, under the operating method, the company recognizes rental expenses, including any applicable accruals. The rental expense is assigned to the periods benefiting from the use of the asset. Under the operating method, the asset and liability are not added to the lessee's balance sheet; therefore, the company's debt-to-asset ratio is not affected (Kieso, 2012).

The impact of a capital or operating lease is also seen in the notes to the financial statements. Retail companies are required by the FASB to disclose certain information about leases in the notes to the financial statements. According to Kohl's 10-K filed with the Securities and Exchange Commission (SEC), as of January 28, 2012, 724 of Kohl's retail stores were subject to either a land or building lease. Kohl's then details the methods used in accounting for both capital and operating leases, along with three main estimates that management must make when accounting for leases: expected lease term, incremental borrowing rate, and fair market value of leased asset. A section from the 10-K regarding leases is as follows:

If we are considered the owner for accounting purposes or the lease is considered a capital lease, we record the property and a related financing or capital lease obligation on our balance sheet. The asset is then depreciated over its expected lease term. Rent payments for these properties are recognized as interest expense and a reduction of the financing or capital lease obligation. If the lease is considered an operating lease, it is not recorded on our balance sheet and rent expense is recognized on a straight-line basis over the expected lease term.

(Kohl's, 2012)
Currently, the International Accounting Standards Board (IASB) and the FASB are working on a joint project to create a single standard regarding lease accounting. The draft was first issued early in 2013 and is still in the proposal stage. The goal of the new standard is to increase transparency in financial reporting and comparability between standards. Transparency is accomplished by requiring lessees to capitalize the majority of leases. Capitalization requires recognizing a lease asset and a lease liability along with disclosing certain information in the notes to the financial statements ("Proposed Accounting," 2013).

The proposed standard changes the way leases are classified. Leases will be classified as either Type A or Type B. Type A leases are leases of assets other than property, such as equipment and vehicles. Exceptions include if the lease term is for an insignificant part of the total economic life of the underlying asset or if the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date. Type B leases are leases of property, such as buildings or land. Exceptions include if the lease term is for the major part of the remaining economic life of the underlying asset, or if the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

Under the proposed standard, the lessee recognizes a lease asset and lease liability on the balance sheet for all leases except short-term leases, which are 12 month or less. The value of the lease is calculated by discounting the lease payments over the life of the lease back to present value at the discount rate being charged by the lessor. The difference between Type A and Type B leases is in the pattern of expenses which are recognized. For Type A leases, lessees would amortize the right-of-use asset on a straight-line basis. The asset would be amortized over the shorter of the lease term or the useful life of the asset. A consistent interest rate would be used,
which will decrease interest expenses as cash payments are made. Total periodic expenses are higher in early periods and lower in later periods. Type B leases would calculate a period lease expense similar to today's operating leases. The lessee would recognize lease expense as the greater of the remaining cost of the lease allocated over the remaining lease term or the periodic interest expense taken on the lease liability. The result is lower periodic expenses in early periods compared to Type A leases. The new lease standards significantly change the way companies account for leases and may increase the burden of recordkeeping (Ernst & Young, 2013).

Along with the new methods of accounting for leases, the FASB has included more disclosure rules in the proposed standard. Under the new method, the lessees must present their leased assets separately from other assets or disclose them in notes to the financial statements. The lessee must also present values from the lease on its statement of cash flows. In the case of Kohl's, the total value of leased assets is currently included in the notes to the financial statements; however, the value of any operating leases is not disclosed within the financial statements ("Proposed Accounting," 2013). The proposed standards help provide a clearer picture of leases held by a retail company. Retailers may see an increase in the number of leases which are accounted for on the balance sheet, which may affect the company's debt ratios. The new ratios can have an effect on any current and future lending arrangements with investors or creditors.

Assets are not the only accounts that can cause issues for retailers. One of the main ways a retailer generates business is through advertising. Advertising can be done in many different ways. A retailer could use television, radio, catalogs, newspapers, or mailed advertisements to generate interest about its products. The cost of advertising greatly affects the company's financial statements. According to GAAP, the majority of advertising costs are expensed, but the
difference is in the timing of the expense (ASC 720-35-25-1). The only exception is direct-response advertising. Direct-response advertising is any type of advertising that entices the consumer to respond directly to the advertisement through a mail-in card, a specific promotional code, or a certain telephone number. To be considered a direct-response advertisement, the company must be able to provide evidence of the relationship between the advertisement and the revenue generated from the advertisement (ASC 340-20-25).

Direct-response advertising can be capitalized if two specific conditions are met, which are defined in the ASC. First, the purpose of the advertisement must be to generate sales from customers who respond directly to the advertisement. To prove the purpose of the advertisement, there must be a record documenting the response that includes the name of the customer and the advertisement that generated the response. The record can take many forms including a telephone log, file of orders, or response cards. Second, the advertising must result in probable future benefits. The ASC requires evidence that the benefits are similar to prior direct-response advertising activities. There must be historical proof of such benefits. If the advertising meets both criteria with the required documentation, the costs are capitalized and amortized over a period decided by the company (ASC 340-20-25).

The most common form of direct-response advertising is catalogs. Even in this digital age, catalogs are still very popular for retail stores. J. Crew is one of the most popular stores who use catalogs. J. Crew began as a mail-order business and has grown to have over 300 stores in the U.S. and Canada. Even with its expansion, J. Crew still mails out 40 million catalogs a year. Catalogs are generating more popularity as retail stores are continuing to use them as a part of their marketing scheme, and others are just beginning to send out catalogs (Fox, 2012). When accounting for the cost of its catalogs, J. Crew capitalizes the cost of its catalogs and mailing
costs and amortizes the balance over a period of two months (J. Crew Group, 2013). Two months is the period of time the company believes it will receive the benefits from the catalogs.

Advertising costs which are not direct-response can be accounted for in one of two ways. The costs can be either expensed as incurred or expensed the first time the advertising takes place. If the costs are expensed when the advertising takes place, the initial cost is recorded as a prepaid expense. Then, when the advertising takes places, the expense is recorded. The policy that is chosen should be consistently applied to similar forms of advertising and should be disclosed in the notes to the financial statements (ASC 720-35-25-1). A retailer cannot generate revenue without some form of advertising. Retailers tend to choose various forms that reach the demographic the store is trying to reach. No matter the form of advertising, the retailer needs to fully understand the options to account for the costs, so that the financial statements provide a realistic view of the company’s operations.

Advertising is the main generator of revenue for retailers, but the brand of the store or specific product is also one of the most important assets of a company. Maintaining a brand image increases customer support and keeps the company operating profitably. According to Interbrand, a consultant, the Coca-Cola brand is worth over $79 billion, even though on its balance sheet, brands are valued at only $6.7 billion. The difference is due to the fact that brands which are internally generated cannot be capitalized in the company’s financial statements. The company cannot record the value of the internally generated brand on its balance sheet. The cost of maintaining and developing the brand is expensed as incurred, mostly through advertising expenses. Even though many experts believe that investors deserve to know the value of a company’s brand, the subjectivity used to generate a brand’s value is the reason the FASB decided to disallow the capitalization of brands ("Untouchable," 2014). Analysts would need to
predict future revenues and discount the net cash flows to arrive at the current value of the brand. The process is extremely complicated and subjective and would provide a higher possibility of a company overstating its assets ("Untouchable," 2014). To adhere to the conservatism principle, companies do not account for internally generated brands on their balance sheets.

Even though internally generated brands and intangible assets cannot be capitalized, those that are purchased in a company acquisition can be capitalized on the balance sheet. The acquired brands are given a value in the purchase price. In 2005, Procter & Gamble paid $57 billion for the Gillette razor company, of which Procter & Gamble believed $24 billion was for the brand name alone ("Untouchable," 2014). The value of Gillette is now on Procter & Gamble’s books. The value of the brand can never be written up to fair value, but it must be tested for impairment.

Impairment occurs if the carrying value of the asset exceeds the fair value of the asset. If impairment occurs, a company must restate the asset to the appropriate fair value. Procter & Gamble explains thoroughly in the notes to the financial statements the process used to determine if brands are impaired. It lists brands as having a total value of over $26 billion (Procter & Gamble, 2014). Even though brands often do not have a large impact on the recorded financial statements of a company, they are the reason for many loyal customers and are extremely valuable and important to a company.

The last two topics that retailers need to pay special attention to deal with revenue recognition. It is extremely important that a retailer follows all the guidelines for revenue recognition so as to not overstate or understate its net income for the period. The revenue recognition principle says that a company should recognize revenue when it is realized and when
it is earned (Kieso, 2012). In simple terms, a retailer has earned revenue when it has exchanged cash or credit for goods and has completed the transaction so as to be entitled to the benefits of the revenue. Revenue recognition can be complicated by some of the promotions and programs a retailer uses to generate business.

Gift cards are the most common way that retailers can generate revenues. During the holiday season, many people purchase gift cards. Gift cards allow the person receiving the gift to buy what they want at their own leisure. Even though the retailer has already received the cash, they cannot record the revenue until the gift card is exchanged for goods. The cash received for the purchase of a gift card is deferred revenue. Most companies record the amount in a liability account until the gift card is exchanged for goods at which time they would record a decrease in inventory, recognize the revenue, and remove the liability (Kile, 2007).

The main difficulty in accounting for gift cards is the fact that not all gift cards will be used. Breakage is the percentage of gift card value that goes unused. The liability account needs to be analyzed for breakage.

Similar to the way that companies account for receivables that will not be collected, companies should analyze previous periods to make an estimate on the amount of gift cards that will not be used. The amount can then be recorded in a variety of ways. The company can recognize the income as part of net sales, part of other income, a reduction of cost of goods sold, or a reduction of selling, general, and administrative expenses (Kieso, 2012). Macy's has a section of the notes to the financial statements detailing the accounting for gift cards and where any breakage is recorded (selling, general, and administrative expenses) (Macy's Inc., 2014).
The disclosure is not required but is a good practice so that investors know exactly how Macy’s accounts for each part of a gift card.

In addition to gift cards, retailers also often use promotional programs to entice consumers to buy from their store. A store loyalty or rewards program is one tactic that retailers utilize. These programs require the customer to sign up with the company and provide certain personal information. The customer then receives various rewards for making purchases from the retailer. These programs entice customers to buy many items from the retailer in order to earn a reward. Rewards programs can boost a company’s sales and overall brand awareness.

There are two main methods to account for the revenues and costs within a rewards program. The first is the “cost/provision” method. Under the “cost/provision” method, companies recognize the full value of the purchase as revenue when points are earned. At the same time, the company records a liability for the future obligations to the customer. The rewards that the company gives out are considered marketing expenses under the “cost/provision” method. The second method is the “deferred revenue” method. Under the “deferred revenue” method, points are considered a separate component of a sale. The company defers a portion of the revenue from the qualifying purchase by creating a liability account. The deferred revenue is recognized in the period in which the customer redeems the points or the points expire (“Loyalty analytics,” 2013). In its notes to the financial statements, Macy’s details its reward programs policies as follows: “The Company recognizes the estimated net amount of the rewards that are earned and redeemed as a reduction to net sales” (Macy’s Inc., 2014). Macy’s offers a clear and concise view of its accounting policies, which allows investors to evaluate its financial statements and make decisions.
The FASB and IASB are currently working on a new standard to make revenue recognition more consistent between standards. On May 28, 2014, the FASB and IASB issued the final standard on revenue recognition which will be effective for public companies for periods beginning after December 15, 2016 and for periods beginning after December 15, 2017 for nonpublic companies. The new standard is a single standard companies to account for revenues arising from contracts from customers.

The standard provides a five step approach for companies to utilize in deciding when to recognize revenue. Step one is to identify the contract with a customer. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Step two is to identify the performance obligations in the contract. A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. Retailers have performance obligations to transfer goods to customers in exchange for cash or credit. Step three is to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods and services to a customer. Step four is to allocate the transaction price to the performance obligations in the contract. If a contract has multiple performance obligations, the company should allocate the transaction price between the obligations based on the selling price of each distinct good or service within each performance obligation. Step five is to recognize revenue when the entity satisfies a performance obligation. An obligation is satisfied when the customer receives control of the good or service ("Revenue," 2014). The new recognition approach is slightly more complicated than the previous standard, but it provides a more consistent way to recognize revenue.
The new revenue recognition standard may not affect the way a retailer accounts for typical product sales; however, it may affect the way a company accounts for gift cards and customer rewards programs. Under the new standard, customer rewards may represent a separate performance obligation within the contract. The entity would then allocate a portion of the transaction price to the obligation and would recognize the revenue either when the customer exercises the right to use the incentive and receives the goods or when the reward expires ("Retail," 2014). The entity needs to exercise caution and professional judgment when determining whether the reward is a separate performance obligation and how to allocate a value to the reward.

The new standard does not change the way a company accounts for the purchase of a gift card. The retailer continues to debit cash and credit a liability account representing deferred revenue. The new standard does, however, change the accounting for unused gift cards. First, the company must identify sufficient historical information indicating a pattern of unused gift cards which can be used to estimate the breakage. If there is sufficient information, the company can recognize the revenue expected from the breakage at the time the customer uses part or the entire gift card. The breakage is calculated "in proportion to the pattern of rights exercised by the customer ("Retail," 2014)." If the entity concludes that it is not entitled to the estimated amount, it has to wait to recognize the revenue until the likelihood of a customer exercising its right becomes remote ("Retail," 2014). The section of the standard covering breakage requires retailers to make significant judgments about the probability of unused gift cards in order to reflect revenue. The new revenue recognition standard requires that all retail companies evaluate their current accounting procedures and implement the new procedures, which may have a direct affect on the financial statements.
Financial statements are the main tool used by investors to evaluate whether a company is profitable and whether it will continue to be profitable. In order for financial statements to be a useful tool for decision makers, they need to be reliable and investors need to be able to understand them. Retailers follow GAAP, and there are specific topics that retailers need to pay special attention to. These topics are especially important to investors because they make up a large amount of the value of the company. The way in which a company values its inventory affects its cost of goods sold and ultimately net income. Net income is needed to be able to pay dividends to investors and reinvest in the company. Lease accounting affects the balance sheet and income statement. Capitalized leases show up on the balance sheet and affect the debt-to-equity ratio. They also affect net income. Operating leases create expenses with a different expense pattern, which affects net income. Retailers use advertising to generate interest and influences customer purchases. Without advertising, stores would not be nearly as profitable. Advertising expenses hopefully generate higher revenues that offset the cost of the advertising. Brands are one way that financial statements may be lacking information for decision makers. The value of a brand is not seen until it is purchased by another company, so retailers like Target and Macy’s cannot show their investors how much the brand is worth to the company. The lack of information can negatively affect decision makers if they over or under estimate the value. Lastly, the way that retailers recognize revenue in regards to gift cards and customer rewards programs affects the financial statements. The different methods can affect liabilities and overalls revenues of the period which affects net income. All of these topics have an impact on the company’s bottom line, which influences decision makers. Financial statements are one way of communicating information to investors and creditors, and if they are inaccurate, the company can be negatively affected.
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