



Consumer products IFRS financial statements survey

October 2011



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Executive summary



The changing environment of International Financial Reporting Standards (IFRS) has a significant and wide-ranging impact on the business operations of consumer products (CP) entities, affecting not only accounting and reporting, but also processes, such as tax planning and compliance, business systems and regulatory compliance.

In this fourth edition of the *Consumer Products IFRS survey*, we have surveyed 20 leading CP entities in Europe, applying IFRS. We have updated our observations from 2009 financial statements and addressed additional issues that have arisen in the current year. **SCA Svenska Cellulosa Aktiebolaget (SCA)** and **Royal FrieslandCampina** were included in the current survey for the first time.

While the standards are now generally well understood and embedded within entities' operations, significant areas of judgement remain. Furthermore, as IFRS and its interpretations (as issued by the IFRS Interpretations Committee) are continuously reviewed and updated to reflect the changing business environment, IFRS compliance is an ongoing challenge for management.

Focus of the survey

The objective of this survey is to analyse industry practice with respect to the key IFRS accounting challenges for CP entities.

Our survey looks at the latest annual consolidated financial statements of 20 leading publicly listed (both equity and debt) CP entities in seven countries across Europe.

The survey is focused on CP-specific IFRS challenges rather than general IFRS topics. The consumer product-specific issues we consider include:

- ▶ Intangible assets including goodwill
- ▶ IFRS 7 disclosures (financial instruments)
- ▶ Hedge accounting
- ▶ Leases exposure draft (ED)
- ▶ Revenue recognition (ED)

Due to the growing demand from investors and analysts, we also address in this survey:

- ▶ Risks and key performance indicators (KPIs)
- ▶ Sustainability reporting

The survey also covers current IFRS amendments and their implications for CP entities. Therefore, we also briefly discuss the potential impact on adoption of the new standards IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*.

Key observations

As IFRS continues to evolve and develop, from year to year changes to current accounting have been unavoidable. This in turn, has further resulted in an incremental volume of information provided in the financial statements.

Additionally, the proposed new standards for leases and revenue recognition will considerably alter information in the financial statements. Under the proposed model for hedge accounting, it will be easier for companies to reflect their economic hedging practices in their financial statements. Companies need to understand the proposals and the potential impact early on, in order to prepare themselves for the changes and to communicate these changes to the users of the financial statements.

One of our main findings has shown that the linkage between communicated strategic priorities, KPIs and risks are not always clearly established in the annual reports. Further communication and explanations would enable management to demonstrate that the chosen metrics are designed to measure achievement against the designated priorities and that the risks of achieving the stated priorities are both identified and appropriately mitigated.

In total this should drive confidence of investors and ultimately stock performance.



Performance review

Within comparable product categories, performance figures vary widely, but in general, the CP entities surveyed performed relatively strongly in 2010.

On average, 2010 EBITDA¹ margins in our surveyed entities were slightly higher than those in 2009. However, return on equity (RoE) in 2010 increased only slowly compared to 2009, mainly due to higher equity bases.

All of the entities surveyed reduced their long-term debt ratio. CP entities have used the opportunity of a strong earnings position in 2010 to repay parts of their long term debts and increase equity.

Risks and KPIs

The number of business risks identified by CP entities, and the level of detail in which they are described, varies significantly across the sector. The survey analyses the main risks identified within the sector, the different ways entities present these risks and the steps taken to mitigate them.

One of our main findings is that the linkages between communicated strategic priorities, KPIs and risks are not always clearly established in the annual reports. Better communication would enable management to demonstrate that the chosen metrics are designed to measure achievement against the designated priorities and that the risks of achieving the stated priorities are identified and appropriately mitigated.

Intangible assets, including goodwill

Brands and goodwill represent significant economic value for CP entities – in some instances, they amount to more than half of total assets. Therefore, there is a significant risk of impairment should CP companies fail to respond to changing consumer tastes or spending patterns.

However, as in the previous year, no significant impairment losses were recognised by the surveyed CP entities. This would indicate that brands are supported by considerable marketing spending and these investments look set to generate sufficient cash flow in the future.

The CP entities in the survey generally allocate their goodwill and brands to segments or one reporting level below segment level. The majority use either the relief from royalty method or a discounted cash flow method to value brands for the purpose of impairment testing. However, there is diversity in practice regarding the parameters used.

Leases

The proposed changes to IAS 17 *Leases* consist of a single model that would virtually eliminate off-balance sheet financing through operating leases. CP entities engaged in leasing arrangements for offices, stores and production premises will need to review the impact on their income statement and balance sheet metrics.

While the impact for the majority of CP entities is expected to be minor, in individual cases, especially in the luxury and apparel subsector, the new model might considerably alter information in the financial statements.

Hedge accounting

IAS 39 will be replaced by IFRS 9 in three phases. Changes in the classification of financial instruments and impairment of financial assets will be considered in the first two phases. The third phase will include a significant change to hedge accounting requirements.

Most CP entities surveyed use hedging strategies to reduce their interest rate risks and foreign currency exchange risks. Some entities are also engaged in hedging commodity price risks.

Although most entities apply some economic hedging, not all entities apply hedge accounting, due either to the strict requirements of IAS 39 or to the administrative burden of the documentation requirements. The Exposure Draft (ED) is likely to have a significant impact on those entities that already apply hedge accounting, as well as others that use economic hedging practices, but are currently unable to reflect this in their financial statements.

Those entities applying hedge accounting present comprehensive information about the types of risks hedged and the instruments used for hedging. Very few, however, present details about the testing of hedge effectiveness.

IFRS 7 disclosures

IFRS 7 *Financial Instruments: Disclosures* requires a number of disclosures for financial instruments and financial risks. Amongst others, entities are required to identify financial risk factors and to present a quantified analysis of their exposure.

Almost all entities identified risks such as foreign exchange risk, interest rate risk, liquidity risk and credit risk, and some entities also analyse their exposure to equity risks and commodity pricing risks.

1. EBITDA is defined as Earnings Before Interest, Tax, Depreciation and Amortisation.

The quantitative data is generally presented using sensitivity analyses, although a minority of entities use Value-at-Risk (VaR) analyses.

Revenue recognition

The proposals for revisions to the model for revenue recognition from contracts with customers are still changing and current decisions remain tentative.

For many transactions common in the CP sector, the ED may not change the timing or amount of revenue recognition. However, there will be instances where this will have an impact, particularly on the accounting for bad debts and in accounting for sales incentives and vendor allowances, product warranties and licences. Considering this development, **maxingvest** and **Nestlé** have reviewed their policy and will apply the new guidance regarding revenue recognition in relation to vendor allowances prospectively from 2011. This will also significantly change revenue-related ratios. In the case of **Nestlé**, the reclassification amounts to 15% of total revenues.

Sustainability reporting

All of the surveyed entities issued a separate sustainability report and included information about their management of environmental and social issues within their annual report. Most entities use the Global Reporting Initiative framework as a basis for reporting.

Although the concept of integrated reporting has not yet been applied due to the lack of a globally consistent reporting standard and no requirements for audit obligation, a majority of entities improved the reliability of the disclosed information by seeking independent assurance.

New standards on consolidation, joint arrangements and disclosures

The introduction - of the three new standards - IFRS 10, IFRS 11, and IFRS 12, is part of the improvement and convergence process between the FASB and the IASB, commonly referred to as IFRS 3.0. One of the main changes relates to the abolition of proportional consolidation for joint ventures (jointly controlled entities). However, since most CP entities surveyed have only insignificant joint ventures, the impact on these companies is deemed to be minor.

Looking at the results of the study and my talks with a large number of CFOs and supervisory board members, I come to the following key conclusions:

1. IFRSs are well understood and have come to be applied consistently by CP companies to a great extent.
2. The globalisation process and the financial crisis have increased the pressure on standard setters to create new standards that are uniformly applicable worldwide.
3. This means that an unprecedented amount of accounting changes is on the horizon. As we have seen with regard to the changes in preparation for the new standard on revenue recognition and the forecasts about the changes in the accounting treatment of leases, the effects can be extensive.
4. In addition to pressure from regulators, shareholders and analysts are also demanding more information. Sustainability reports have now become standard for CP companies. Further developments relate to forward-looking and risk-based information.
5. Assuming companies comply with these wishes, annual reports with significantly more than 300 pages will be commonplace, overwhelming readers with a mass of information.
6. Consequently, the International Integrated Reporting Committee (IIRC) aims to achieve integrated, more meaningful and more compact reporting.

Companies need to understand the proposals and to begin assessing the potential impact, preparing for the changes. Not only can there be significant impact on key financial statement performance indicators, it will also be necessary to implement new processes in the financial reporting systems in order to gather the relevant information.



Thomas Harms, IFRS Leader, Consumer Products, Ernst & Young



Focus of the study



Our survey focused on the following 20 leading European CP entities. We analysed annual financial statements published up to 30 March 2011.

Entities surveyed

| Entity | Location | SEC listing | Financial year-end |
|---|----------------|-------------|--------------------|
| adidas | Germany | No | 31 December 2010 |
| Anheuser-Busch InBev | Belgium | No | 31 December 2010 |
| Beiersdorf/Tchibo* | Germany | No | 31 December 2010 |
| British American Tobacco | UK | No | 31 December 2010 |
| Christian Dior/Louis Vuitton Moët Hennessy (LVMH)** | France | No | 31 December 2010 |
| Compagnie Financière Richemont | Switzerland | No | 31 March 2011 |
| Diageo | UK | Yes | 30 June 2010 |
| Danone | France | No | 31 December 2010 |
| FrieslandCampina | Netherlands | No | 31 December 2010 |
| Heineken | Netherlands | No | 31 December 2010 |
| Henkel | Germany | No | 31 December 2010 |
| Imperial Tobacco Group | UK | Yes | 30 September 2010 |
| L'Oréal | France | No | 31 December 2010 |
| Nestlé | Switzerland | No | 31 December 2010 |
| Pernod Ricard | France | No | 30 June 2010 |
| PPR | France | No | 31 December 2010 |
| Reckitt Benckiser Group | UK | No | 31 December 2010 |
| SABMiller | UK | No | 31 March 2011 |
| SCA | Sweden | No | 31 December 2010 |
| Unilever | UK/Netherlands | Yes | 31 December 2010 |

* Beiersdorf/Tchibo are both subsidiaries of maxingvest. We have analysed the financial statements of maxingvest.

** Christian Dior and Louis Vuitton Moët Hennessy have been treated as one entity for the purpose of this survey (financial statements of Christian Dior as of 31 December 2010).

We analysed the key performance measures of the selected entities as shown in their latest published annual consolidated financial statements.

Highlights from financial statements (all amounts in millions of euros)

| Entity | Revenue * | % change from prior year | Net income | % change from prior year | Total assets | % change from prior year |
|--------------------------------|-----------|--------------------------|------------|--------------------------|--------------|--------------------------|
| adidas | 11,990 | 15% | 568 | >100% ^(a) | 10,618 | 20% |
| Anheuser-Busch InBev | 27,451 | 4% | 4,358 | 3% | 85,573 | 10% |
| Beiersdorf/Tchibo | 9,595 | 8% | 554 | 34% | 12,618 | 7% |
| British American Tobacco | 17,358 | 9% | 4,596 | 38% | 32,496 | 8% |
| Christian Dior/LVMH | 21,123 | 19% | 3,269 | 72% | 41,197 | 14% |
| Compagnie Financière Richemont | 6,892 | 33% | 1,079 | 80% | 9,693 | 25% |
| Danone | 17,010 | 14% | 2,034 | 34% | 28,099 | 15% |
| Diageo | 11,406 | 4% | 2,033 | 0% | 22,691 | 7% |
| FrieslandCampina | 8,972 | 10% | 285 | 57% | 5,299 | 11% |
| Heineken | 16,133 | 10% | 1,568 | 37% | 26,549 | 32% |
| Henkel | 15,092 | 11% | 1,143 | 82% | 17,525 | 11% |
| Imperial Tobacco Group | 17,515 | 4% | 1,775 | >100% ^(b) | 35,709 | 3% |
| L'Oréal | 19,496 | 12% | 2,242 | 25% | 24,045 | 3% |
| Nestlé | 79,509 | 12% | 25,641 | >100% ^(c) | 89,099 | 19% |
| Pernod Ricard | 7,081 | -2% | 978 | 1% | 27,107 | 9% |
| PPR | 14,605 | 8% | 1,015 | 2% | 24,695 | 1% |
| Reckitt Benckiser Group | 9,859 | 13% | 1,831 | 15% | 15,562 | 59% |
| SABMiller | 11,510 | 14% | 1,943 | 31% | 27,767 | 0% |
| SCA | 11,445 | 9% | 587 | 29% | 15,891 | 9% |
| Unilever | 44,262 | 11% | 4,598 | 26% | 41,167 | 11% |

* Revenue net of duty and similar items

(a) adidas' increased gross profit had a direct positive effect on net income

(b) Imperial Tobacco Group has minimised fair value losses on derivative financial instruments providing commercial hedges compared with 2009

(c) Increase in net income mainly relates to net other income from discontinued operations due to the disposal of Alcon for CHF24,521m (€17,769m)

Highlights from financial statements (all amounts in millions of euros)

| Entity | Equity | % change from prior year | Goodwill | % change from prior year | Brands | % change from prior year |
|--------------------------------|--------|--------------------------|----------|--------------------------|--------|--------------------------|
| adidas | 4,623 | 22% | 1,539 | 4% | 1,447 | 8% |
| Anheuser-Busch InBev | 29,037 | 26% | 39,289 | 9% | 16,203 | 8% |
| Beiersdorf/Tchibo | 7,859 | 8% | 1,879 | -2% | 3,502 | -1% |
| British American Tobacco | 11,137 | 25% | 13,216 | 3% | 813 | 3% |
| Christian Dior / LVMH | 19,570 | 21% | 5,660 | 15% | 11,772 | 4% |
| Compagnie Financière Richemont | 6,992 | 24% | 441 | 169% | 0 | n/a |
| Danone | 11,987 | 13% | 11,213 | -13% | 4,255 | 9% |
| Diageo | 5,582 | 21% | 467 | 9% | 5,797 | 7% |
| FrieslandCampina | 2,071 | 18% | 838 | 0% | 0 | n/a |
| Heineken | 10,517 | 86% | 7,313 | 35% | 2,158 | 69% |
| Henkel | 7,950 | 21% | 6,521 | 6% | 2,031 | 3% |
| Imperial Tobacco Group | 8,269 | 15% | 15,227 | 2% | 7,718 | -1% |
| L'Oréal | 14,866 | 9% | 5,730 | 5% | 1,229 | 5% |
| Nestlé | 49,958 | 38% | 21,573 | 17% | 4,747 | 60% |
| Pernod Ricard | 9,337 | 23% | 5,393 | 10% | 12,271 | 9% |
| PPR | 11,651 | 6% | 4,540 | -18% | 9,856 | 1% |
| Reckitt Benckiser Group | 5,984 | 32% | 3,226 | 73% | 8,000 | 60% |
| SABMiller | 16,159 | 6% | 8,486 | -1% | 2,893 | -5% |
| SCA | 7,538 | 15% | 1,966 | 6% | 222 | 29% |
| Unilever | 15,078 | 20% | 13,178 | 6% | 4,532 | 12% |

For the purposes of this survey, we have grouped the entities by their primary product categories, as set out in the table below.

Entities by product category

| Nature of products | Entity |
|-----------------------------------|--|
| Beverage | Anheuser-Busch InBev, Pernod Ricard, Heineken, Diageo, SABMiller |
| Food | Danone, Nestlé, Unilever, FrieslandCampina |
| Household and personal care (HPC) | L'Oréal, Beiersdorf/Tchibo, Henkel, Reckitt Benckiser Group, SCA |
| Tobacco | British American Tobacco, Imperial Tobacco Group |
| Luxury and apparel | Christian Dior/LVMH, PPR, adidas, Compagnie Financière Richemont |



Economic revival of CP entities

2010 marked a revival for the CP industry in terms of revenue growth and net income. Efficiency and cost-saving programmes had a positive impact on entities' 2010 results.

Nearly all of the entities in our survey achieved an increase in turnover, with most of them, 12 out of 20, achieving double-digit growth. The luxury and apparel subsector, which was hit hardest by the impact of the financial crisis in 2009, rebounded with an average growth in turnover of 19%.

Net income increased across all subsectors by 53% on average, with **Nestlé** achieving a threefold increase compared with 2009. This result was mainly influenced by the profit on disposal of 52% of Alcon's outstanding capital. While starting from relatively low levels in 2010, more than half of the companies exceeded their 2008 pre-financial crisis results.

Most CP entities surveyed were also able to improve profitability in terms of EBITDA margin, or at least keep it stable.

Challenges in the improving global economy

Despite the erratic economic recovery in many markets, CP entities are confronted with harsh challenges.

Achieving growth in established markets has become more difficult, as the gap between price-conscious consumers and premium buyers increases. Both groups demand more value for money. Changing shopping habits and the switch to private label has further stepped up the pressure on brand manufacturers and made some promotions less effective. As consumers spend more time online, CP entities also need to shift advertising from traditional to digital media.

On the other hand, emerging and developing markets represent an overwhelming opportunity for growth and profit for CP entities. The majority of the 20 entities in our survey generate a considerable share of revenues within the BRIC (Brazil, Russia, India, China) countries and other developing markets. For example, **SABMiller's** share of group profit in Latin America, South Africa, Africa and Asia amounts to 79%.

The positioning of products in multiple price tiers and channels from luxury to volume, as well as tailoring them to specific cultural needs and preferences, remains the major challenge.

Acquisitions are increasingly seen as an effective way to enter these markets. **Heineken**, for example, acquired 100% of **FEMSA's** Mexican beer operations in 2010.

M&A activity is also proceeding apace in established markets: **Reckitt Benckiser** acquired **SSL International plc**, and **Nestlé** acquired **Kraft's** frozen pizza business in North America. While the consolidation of retailers and their increasing global reach puts pressure on CP entities, **Richemont**, for example, is countering this by obtaining effective control of 93% of a luxury fashion online retailer, while others seek to be viewed as strategic suppliers by major retailers.

Responding to increasing commodity prices, which are now above the levels of mid-2008, CP entities are using a combination of hedging, further cost savings and aligned pricing strategies to keep margins relatively robust. Nevertheless, margins might be hit in the future by rising commodity prices and stable revenues, as long-term hedges secure low commodity purchase prices for a limited time frame only.

Corporate responsibility issues around areas such as governmental regulation regarding product safety, as well as increased consumer focus on businesses' ethical behaviour, are becoming a major topic on many CP boardroom agendas. Companies are responding by putting more effort into transparent communication of non-financial information.

For our analysis of the financial performance of the 20 CP entities in our sample, we have used the financial ratios calculated and published by OneSource Information Services, Inc., in July 2011. The exceptions are **maxingvest**, where we used the OneSource figures provided for **Beiersdorf**, maxingvest's major subsidiary. Since data relating to **Henkel** and **FrieslandCampina** was not available from OneSource, data was taken from Bloomberg and based on Ernst & Young's calculations.



Performance of CP entities

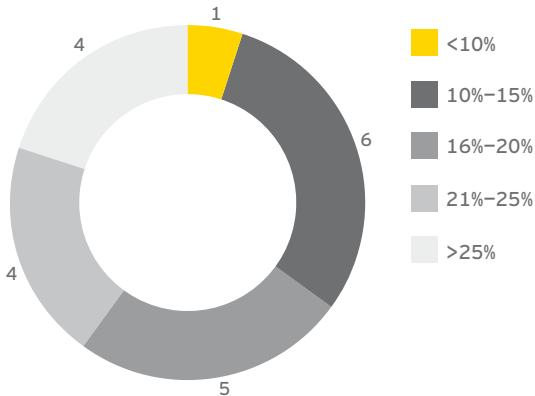
Financial performance figures

As in 2009, the financial performance of CP entities in 2010 differed widely.

Keeping EBITDA margins steady

The following graphic illustrates CP entities' five-year average EBITDA margins,² which measure operating profitability.

Five-year average EBITDA margin



Remarkably, eight of the entities surveyed realised an EBITDA margin of more than 20% over the past five years, which underpins the strong margin-driven performance of this sector.

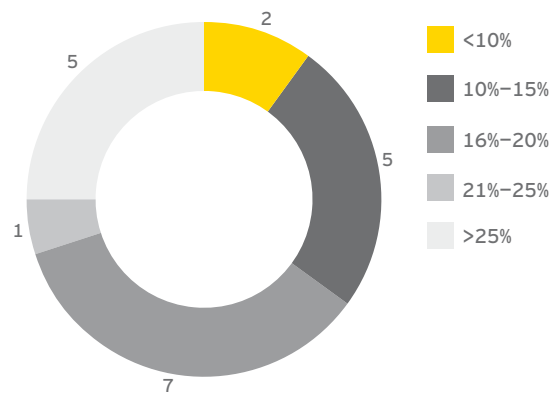
Comparing the 2010 figures with the average of the four prior years, 10 entities realised an EBITDA margin exceeding their 2006 to 2009 average. On average, EBITDA margins in 2010 were slightly higher (19.5%) than in 2009 (18.7%) and in the four prior years (average: 18.7%).

While the levels of turnover and net income were significantly higher, EBITDA margin increase was lagging behind.

Return on equity (RoE) slowly rising

The RoE³ realised on average in 2010 (18.9%) was higher than the average of 2009 (17.7%) but still below the average of the four prior years (21.6%). Ten entities surveyed managed to earn profits from every unit of shareholders' equity more effectively than in the four prior years, especially in the food and luxury sectors.

Five-year average RoE



One explanation for the comparatively slowly rising RoE ratios is the relatively high equity base. In 2010, nearly all of the 20 entities surveyed increased their equity, compared with 2009. The equity increase was mainly achieved internally by retaining earnings profits.

Debt-to-equity ratios falling

The impact of the financial crisis can still be observed in changes to the debt-to-equity ratio,⁴ which indicates the proportions of equity and debt an entity uses to finance its assets.

Compared with 2009, all 20 entities decreased their long-term debt or held it at the same level. The average long-term debt ratio across the 20 surveyed entities decreased from 74.1% in 2009 to 57.3% in 2010, partly as a result of the increased equity base referenced above.

In our 20-entity sample, the average long-term debt-to-equity ratio ranged from 0% to 262%. In 2010, six entities were facing a five-year average long-term debt-to-equity ratio of more than 100%, which is one less than 2009. The remaining 14 entities had less long-term debt than equity.

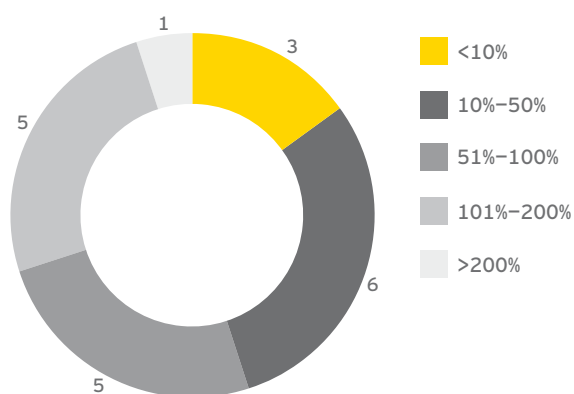
2. EBITDA divided by total revenues.

3. Net income divided by average equity at the beginning and the end of the period.

4. Long-term debt divided by total equity.



Five-year average long-term debt to equity



On average, over the past five financial years, 11 entities had a long-term debt-to-equity ratio of more than 50%. This indicates that many entities have been using debt instruments to finance their growth. The decrease indicates that CP entities used the opportunity of the good earnings position in 2010 to repay parts of their long-term debt and to increase their equity base, although interest rates remained low throughout 2010.

Operational performance

Operational performance figures are independent of the financing of entities. Therefore they reveal information about the actual operational success of the business. As the operations of the entities surveyed are different in nature, we have compared only those entities that operate in the same product category as defined in the focus of the study chapter.

The EBIT margin⁵ indicates the proportion of revenue earned that is available for distribution to the capital providers, whether debt or equity.

Asset turnover⁶ shows the actual utilisation of the assets by the entity. The higher the asset turnover, the more revenue is generated for a given set of assets.

The return on assets (RoA) ratio⁷ shows the amount of earnings that were generated from invested capital and is a measure of how effectively an entity employs its assets.

5. EBIT divided by total revenues

6. Total revenues divided by average assets

7. EBIT divided by assets

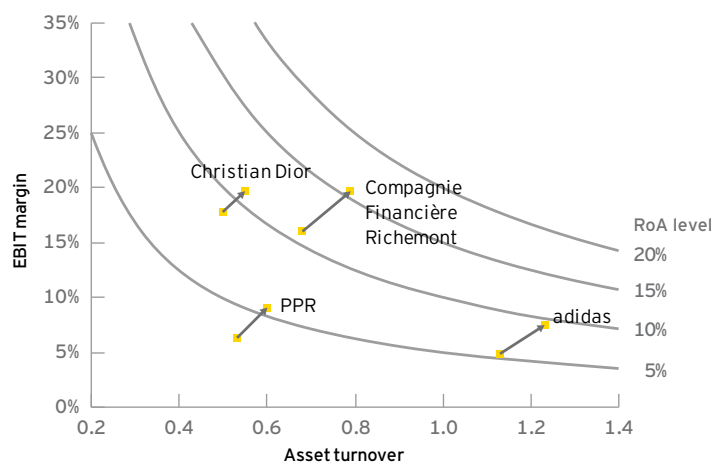
EBIT margin multiplied by the asset turnover is equal to the return on assets, as can be seen in the following formula:

$$\frac{\text{EBIT}}{\text{Revenue}} * \frac{\text{Revenue}}{\text{Assets}} = \frac{\text{EBIT}}{\text{Assets}}$$

The following graphical illustrations depict this relationship. The hyperbolas show the combinations of EBIT margin and asset turnover that result in an identical level of RoA. The innermost hyperbola represents a level of 5% RoA, followed by levels of 10%, 15% and 20%.

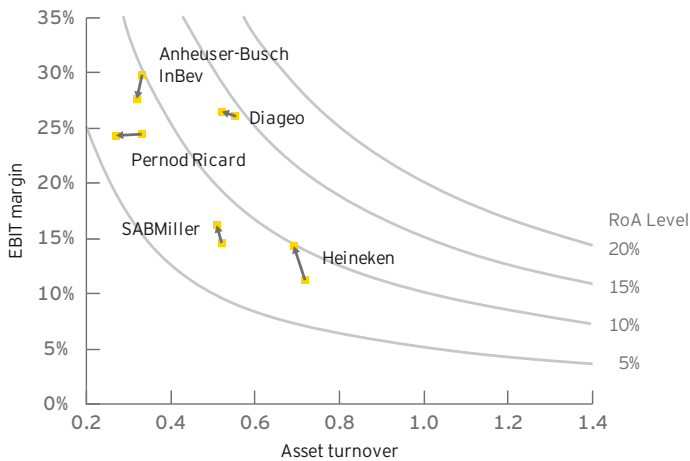
The arrows in the following charts depict the development of RoA levels by CP entity from the prior year.

Luxury and apparel: returning to form



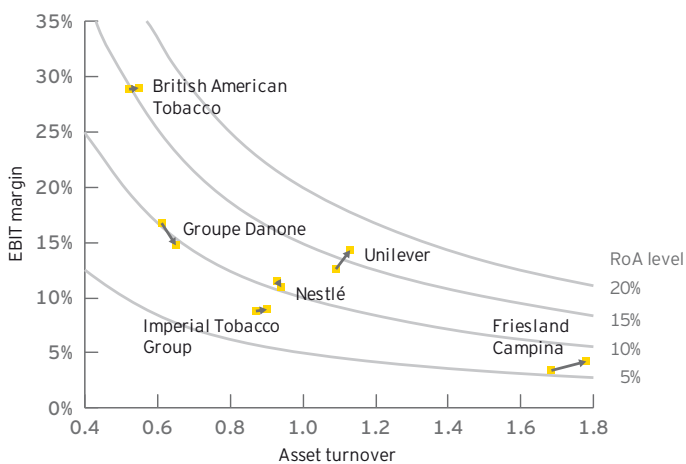
Performance showed a clear trend in the luxury and apparel segments towards higher RoA levels. Dior and Richemont realised a return on assets of 11% and 16%, respectively, which was driven by high EBIT margins as well as higher asset turnover rates. PPR and adidas achieved returns on assets ranging from 5% to 10%, with adidas having one of the highest asset turnover levels amongst the entities surveyed. This result is a function of pricing strategy: that is, entities with lower prices (and usually lower profit margins) tend to have higher asset turnover, while those with higher prices (and usually higher profit margins) have lower asset turnover. In the case of PPR, the entity runs business segments with different pricing strategies. Therefore, a lower EBIT margin and asset turnover led to a low return on assets.

Beverage: lower asset turnover



The beverage sector showed lower asset turnover rates in 2010 compared with 2009, while EBIT margins did not indicate a uniform trend across the surveyed entities. **Anheuser Busch InBev**, **Diageo** and **Pernod Ricard** were able to keep EBIT margins on a comparable level, while **Heineken** and **SABMiller** increased EBIT margins, resulting in a slightly higher RoA level. While most of the companies achieved a similar level of RoA between 5% and 10% in 2010, **Diageo** emerged as the strongest entity due to its high EBIT margin and a RoA of 13.7%.

Food and tobacco: holding firm



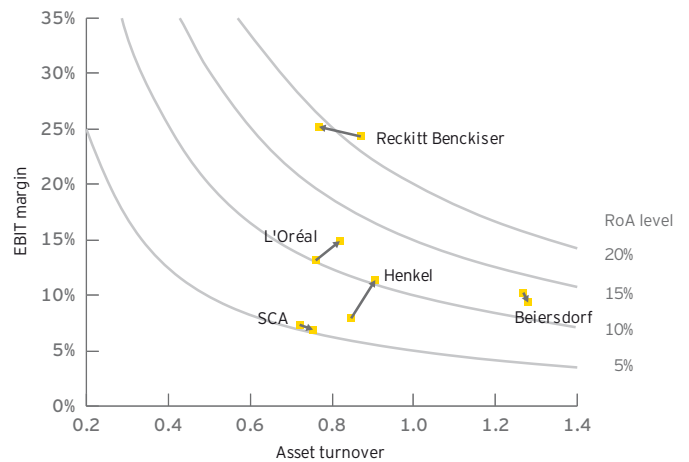
RoA positions did not change notably in the food and tobacco sectors in 2010. While all entities achieved generally higher asset turnover rates, EBIT margins moved in different directions.

In 2010, **Unilever** achieved a much higher RoA compared with 2009 by maintaining a high asset turnover rate as well as achieving a higher EBIT margin on the same level as **Danone**. **Nestlé** maintained its position versus 2009 with a slightly lower EBIT margin.

The two tobacco entities maintained their position compared with the prior year. **British American Tobacco** achieved a high EBIT margin, but with a lower asset turnover. Whereas **Imperial Tobacco's** asset turnover was average for this group, combined with an EBIT margin of 9%, it realised a rather low RoA.

Ongoing regulatory restrictions in the tobacco industry suggest that, in future, this industry may face further pressure. This is likely to have an adverse effect on the entities' financial ratios.

Household and personal care: Henkel revived



Performance in the household and personal care (HPC) category was varied, primarily due to the wide number of product ranges. Repeating its 2009 performance, **Reckitt Benckiser** was the strongest entity in our survey, realising the highest RoA in 2010 (19.4%). This was due to an outperforming EBIT margin. In contrast, **L'Oréal** and **Beiersdorf** achieved only about half of this level. While **L'Oréal** benefited from a higher EBIT margin, **Beiersdorf** generated one of the highest asset turnover rates.

At over 50%, **Henkel** achieved the highest ROA increase in the HPC sector, driven by a strong recovery of the adhesive technologies business sector, while **SCA** maintained a low RoA due to a relatively low EBIT margin.

Key findings

The CP entities surveyed performed relatively strongly in 2010. On average, EBITDA margins were slightly higher than in 2009. More than half of the entities were able to realise a five-year average margin of more than 20%. RoE levels in 2010 increased only slowly compared with 2009, mainly because of increased capital bases. Half of the entities surveyed reduced their long-term debt ratio for the same reason.

In terms of operational performance, many entities achieved a higher RoA compared with 2009. Even within comparable product categories, however, performance figures vary widely, with only the luxury and apparel sector showing a clear upswing. While some entities enjoy very high asset utilisation, others have a higher EBIT margin (due to a higher pricing strategy or lower cost base), but a low level of asset turnover.





Risks and KPIs

Effective risk management at global firms is a live issue.

Reflecting this, Ernst & Young recently published the fourth edition of its *Business Risk Report*, a global survey of more than 700 leading organisations in 15 countries across 7 sectors. In addition, we analysed sector-specific risks for the CP industry in the study *Top 11 risks in consumer products in 2011*.⁸

Risks on the global CP radar

The risk radar resembles Ernst & Young's Risk Universe™ and shows the top 11 CP risks based on qualitative interviews with sector-specific executives, academics and analysts. Risks that were named more frequently can be found in the centre of the radar and are therefore deemed to be more critical.

CP risk universe

We analysed on the annual reports of all 20 surveyed CP entities in terms of their reporting on risk management, and ranked the risks according to frequency of mention. In a second step, we reviewed the KPIs cited in the reports that measure the success of mitigating actions by the entity.

The number of risks disclosed by the CP entities ranged from 7 to 38, with an average of 25.

Within the surveyed group, there was a wide range in terms of depth of coverage of the identified risks. For example, **Unilever's** report includes a table describing both the risks identified and the actions taken by the entity to manage the risks. In a similar fashion, **Imperial Tobacco Group plc** first categorises the principal risks; secondly, it briefly describes and puts each risk into context; and finally, it outlines measures taken to mitigate the risk.



8. Both Ernst & Young *Business Risk Reports* are available at <http://www.ey.com/GL/en/Industries/Consumer-Products>.



Matching risks and KPIs

The linkages between communicated strategic priorities, KPIs and risks are not always clearly established in the annual reports. While some CP entities explicitly identify their KPIs, others do not. In the latter case, we have gathered the information from the Group Management Report or the business review section (chief executive's or chief financial officer's review) in the annual reports.

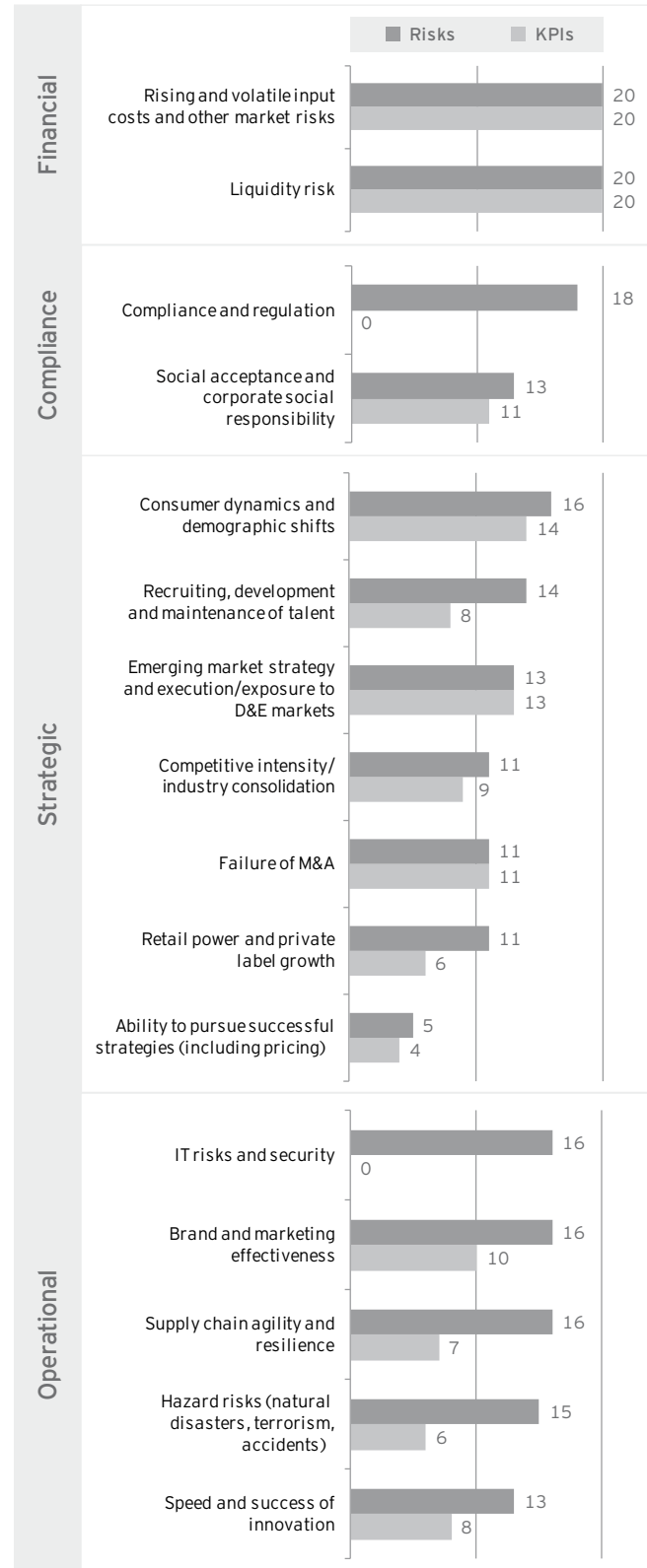
As a result of the variety of source materials, we have had to use a degree of judgement in assessing whether a stated KPI relates to a risk named in a different part of the report. In our view, while some entities do link risks to KPIs effectively, other entities have substantial scope to improve.

KPIs mentioned by more than 50% of the CP entities surveyed are: revenue growth, operating profit and net profit, free cash flow, and earnings per share. While these KPIs are generally directly evident, for example from the income statement, and are influenced by diverse risk factors, specific risk-related KPIs are scarce.

Our approach of matching risks and KPIs included only specific KPIs, and we did not consider general metrics such as revenue or operating cash flow. Since the matching is based on judgement, there is room for interpretation. Nevertheless, the results show a trend that some major risks are addressed better than others.

In our view, entities that addressed those risks more specifically would be better able to demonstrate that the chosen metrics are effective and that the risks are identified and appropriately mitigated.

The following table compares the number of entities that mentioned risks in the annual reports with the number of matching KPIs. The tables in the appendix show the key risks in detail.



Most of the risks identified in the *Business Risk Report* correspond with those named in the annual reports.

Both our survey and the *Business Risk Report* highlight compliance risk and talent management. However, there were some discrepancies, particularly around pricing pressure, where the annual reports failed to define and measure the risk. In part this may be due to differences in data gathering, but it is also reflective of a mismatch between the risks executives describe in a general sense and those they decide to disclose in their financial reporting. Companies need to adapt to this new form of reporting.

Financial

Rising and volatile input costs: market and liquidity risks

These risks were most frequently mentioned by the CP entities we surveyed, combining issues such as commodity price shocks, equity market, foreign exchange and interest rate volatility as well as recession and other economic, social and political uncertainties. All of the entities consider at least one of these issues in their annual report.

The high number of mentions of market and liquidity risks is mainly, but not solely, due to the disclosure requirements under IFRS 7 in the notes to the financial statements.

KPIs that address these risks include financial measures such as debt coverage ratio or other measures, for example ratings by agencies.

Henkel, for example, describes the following financial ratios regarding capital management:

“Our financial management is based on the key performance indicators set out in our financial strategy. In 2010 the interest coverage ratio was 12.8 (previous year: 8.7), while operating debt coverage was 71.4% (previous year: 41.8%). The equity ratio was 45.4% (previous year: 41.4%).”

Henkel, Annual Report 2010, page 115

Compliance

Compliance and regulatory risk

Risks related to compliance and regulations were considered by 18 entities and comprise risks arising from a variety of legal and contractual obligations, litigation directed either at the industry or at the company, issues concerning regulatory constraints on products, imports and exports as well as changes in taxes and duties. For many of the companies we surveyed, especially in the tobacco industry, changes in the regulation of labelling, advertising, distribution, environmental issues and the health agenda were of great concern.

For example, **British American Tobacco (BAT)** describes regulatory risks as follows and adds a detailed matrix with causes, impact and mitigating activities:

“The Group’s businesses operate under increasingly stringent regulatory regimes around the world. Further regulation is expected, particularly as a result of the World Health Organisation’s Framework Convention on Tobacco Control (FCTC) and, increasingly, active tobacco control activities outside the FCTC. [...]

Strict and restrictive regulation in these areas may impair the Group’s ability to communicate with adult smokers and/or to meet consumer expectations and may also impact on its ability to communicate with its corporate stakeholders. In addition, increased regulation may lead to increased operating costs and reduced sales.

Principal activities in place to address risk:

Group companies have regulatory strategies in place in order to identify issues material to their operating environment and develop plans to address them in a manner consistent with local law and Group policy. [...] Global monitoring of regulatory trends and developments and analysis of regulatory proposals to determine impacts, if any, on business.”

BAT, Annual Report, page 47



Social acceptance and corporate social responsibility

Risks concerning social acceptance and corporate social responsibility (CSR) are also the subject of increasing attention. They were noted by 13 of the 20 surveyed CP entities in their annual reports.⁹ These risks arise from increasing social and political scrutiny of companies in respect of their stance on environmental and health issues, ingredients and labour standards. Furthermore, some of our surveyed CP entities explicitly articulated risks arising from the environmental impact of their businesses, climate change or unsustainable sourcing in their annual reports. A few CP entities also refer to risks related to non-compliance with rules and standards that guide appropriate and responsible business behaviour.

More than half of the entities we surveyed have an explicit sustainability KPI disclosed in their annual report, and nearly all apply the Global Reporting Initiative Guidelines to their reporting on sustainable issues in a separately published sustainability report. If entities were to adopt an integrated approach to sustainability reporting, this risk would achieve a much higher ranking.

Strategic

Consumer dynamics and demographic shifts

Consumer dynamics and demographic shifts, including macroeconomic impacts, such as recession leading to weaker consumer demand as well as other economic, social and political uncertainties, are considered principal risks by the majority of entities we surveyed.

As this is a general risk, which is difficult to mitigate, its impact on financial performance is stated only in broad terms in most of the annual reports. For example, **Anheuser-Busch (AB) InBev** states:

“AB InBev is exposed to the risk of a global recession or a recession in one or more of its key markets, and to credit and capital market volatility and economic and financial crisis, which could result in lower revenue and reduced profit, as beer consumption in many of the jurisdictions in which AB InBev operates is closely linked to general economic conditions and changes in disposable income. A continuation or worsening of the levels of market disruption and volatility seen in the last three years could have an

adverse effect on AB InBev’s ability to access capital, on its business, results of operations and financial condition, and on the market price of its shares and ADSs.”

AB InBev, Annual Report, page 58

Innovation failure

Another strategic risk relates to a failure of continuous innovation or a failure to predict changing consumer behaviour and demand. Variations on this risk were articulated by 13 companies.

This is described by PPR as follows:

“The inability to anticipate changes in consumer expectations represents one of the threats to the Group’s activities. The Group’s efforts to ensure a swift response to this threat have focused on streamlining the supply cycle, and in particular cutting the lead time between product design and launch phases. PPR also encourages its brands to strive to stay ahead of consumer trends through a permanent watch over market trends via trade fairs, trend forecasting agencies, consumer surveys, and the like. They also play a major role as trend setters for consumers, through new product and service offerings.”

PPR, Annual Report 2010, page 168

This risk is also closely related to the risk of speed and success of innovation. **Henkel** therefore defines the innovation rate as a matching KPI in its strategy:

“With innovation rates* of around 40% in the business sectors laundry and home care and cosmetics/toiletries, and of around 24 percent at Adhesive Technologies, we count among the strongest innovators in our fields of competence. We are helped in this respect by the proximity we have to our consumers and customers, actively incorporating both audiences in our product development activities where appropriate.”

*Percentage share of sales accounted for by new products launched onto the market in the last three years (five years for Adhesive Technologies).

Henkel, Annual Report, page 41

9. As identified in the section “Sustainability Reporting,” all 20 entities address CSR risks and KPIs in detail in their separate sustainability report. With regards to “integrated reporting,” we focused on CSR risks and KPIs explicitly stated in the Annual Report only in this chapter.

Emerging and developing markets

Emerging and developing markets are viewed as a strategic growth opportunity by the majority of entities. Thirteen companies address specific risks relating to the political and legal environment, competitive pressure or buying behaviour. In this context, the most often mentioned KPI is the contribution made to revenue and EBIT by the emerging markets.

Operational

The principal operational risks disclosed relate to IT risks and security as well as to supply shortages, increased prices, product quality and safety and supply chain disruption. Moreover, a majority of entities identify managing talent and maintaining brand effectiveness as key risks in this category.

Supply chain resilience and agility

Risks related to supply chain resilience and agility are described by **Henkel** as follows:

“We combat price and supply risks by adopting a comprehensive risk management approach. This involves the pro-active management of our vendor portfolio and utilisation of our globally engaged, cross-divisional sourcing capability together with strategies aimed at securing both price and volume through the conclusion of contracts.”

Henkel, Annual Report 2010, page 79

Managing talent

Managing talent ranks amongst the top 10 risk factors in the CP industry as identified in these companies' annual reports.

SCA describes its risks and actions as follows:

“SCA must have access to skilled and motivated employees and safeguard the availability of competent managers to achieve established strategic and operational objectives.

SCA's strategic manpower planning secures access to people with the right expertise at the right time. Recruitment can take place both externally and internally, and internal recruitment and job rotation are facilitated by a “job portal,” where available positions are advertised both internally and externally. Salaries and other conditions are to be adapted to the market and linked to SCA's business

priorities. An established succession planning programme protects operations.

SCA endeavours to maintain good relationships with union organisations.”

SCA, Annual Report 2010, page 47

Brand effectiveness

Brand effectiveness is a key asset for the majority of CP companies we surveyed. As a result, 16 of the 20 noted risks related to brand image and reputation. These risks comprise concerns about product quality and safety, ingredients, contamination and issues regarding the protection of intellectual property, product counterfeiting and illicit trade.

Dior describes this risk as follows:

“The reputation of the Group's brands rests on the quality and exclusiveness of its products, their distribution networks, as well as the promotional and marketing strategies applied. Products or marketing strategies not in line with brand image objectives, inappropriate behavior by brand ambassadors, as well as detrimental information circulating in the media might endanger the reputation of the Group's brands and adversely impact sales.”

Dior, Annual Report, page 21

Entities from the beverage sector, such as **Heineken**, **AB InBev**, **Pernod Ricard** and **SABMiller**, focus on growth in revenue or volumes of core brands as a key operating metric. A KPI of this nature appears to link well with the strategic priority of many CP entities to develop strong brands and to respond to image and reputational risks.

SABMiller, for example, measures “Revenue growth in premium brands” in order to “monitor progress in building our portfolio of global and local premium brands” (**SABMiller, Annual Report, page 19**).

Key findings

The number of business risks identified by CP entities and the level of detail in which they are described varies significantly across the sector.

The linkages between communicated strategic priorities, KPIs and risks are not always clearly established in companies' annual reports.

Better communication would enable management to demonstrate that the chosen metrics are designed to measure achievement against the designated priorities and that the risks of achieving the stated priorities are identified and appropriately reduced.



Intangible assets: valuing brands and goodwill is a key performance driver

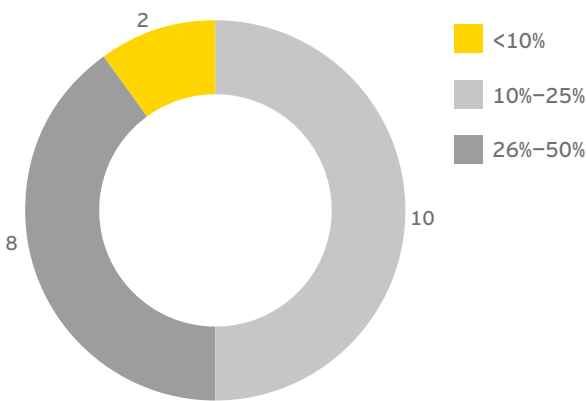
Brands and goodwill represent a significant source of economic value for CP entities – in some instances, brands and goodwill together amount to more than half of total assets. Their valuation and especially the decision about possible impairments to these assets is a major performance indicator for CP entities.

Accounting for intangible assets is subject to significant judgement and is consequently a regular topic for discussion within the industry. The key issues relate to purchase price allocation, the distinction between goodwill and brands at initial recognition, and the subsequent measurement of goodwill and brands. The impairment testing approach required by IAS 36 *Impairment of Assets* requires judgemental decisions, which may lead to a range of outcomes.

Goodwill and brands – a major source of value

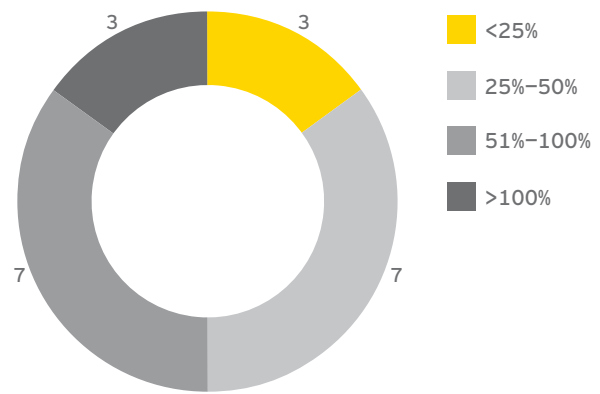
The following graphics illustrate the 20 companies' proportion of goodwill and brands compared with total assets and shareholders' equity.

Goodwill as percentage of total assets



Eight CP entities in our survey (eight in 2009) recognised goodwill that accounted for from 25% to 50% of total assets.

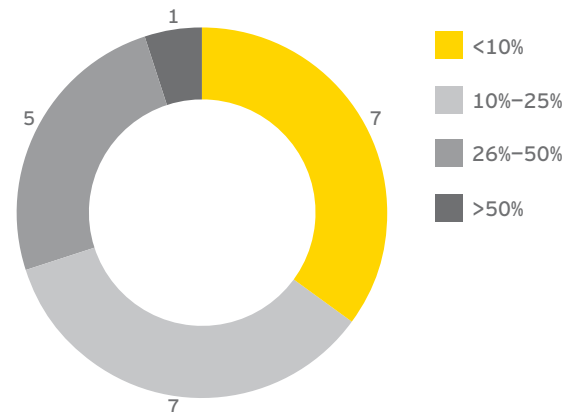
Goodwill as percentage of shareholders' equity



Ten CP entities (12 in 2009) recognised goodwill amounting to more than half of shareholders' equity, and in three cases (four in 2009), goodwill exceeded shareholders' equity. This decrease, compared with 2009, is due to an increase in shareholders' equity which, in most cases, exceeded the relative change in goodwill.

Transaction activity in the CP sector increased in 2010. Deal volumes are now at their highest level in the last two years with megadeals reappearing. Readers are referred to the Q4 2010 and subsequent editions of *Consumer Products Deals Quarterly*.¹⁰

Brands as percentage of total assets

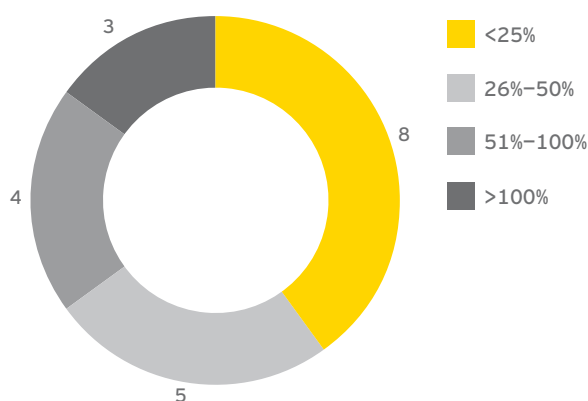


10. <http://www.ey.com/GL/en/Industries/Consumer-Products/Consumer-Products-Deals-Quarterly--October-December-2010---Recovery-still-building->



About onethird of the entities in our survey recognised brands as representing more than 25% of total assets in 2010, a similar proportion to the previous year.

Brands as percentage of shareholders' equity



For seven CP entities (eight in 2009), brands represented more than half of shareholders' equity, while for three entities, brands exceeded shareholders' equity.

Impairments on goodwill and brands remain at a negligible level

Goodwill and intangible assets with an indefinite useful life are not amortised, but tested for impairment on an annual basis. The judgements and estimates used for impairment testing purposes can have a significant financial impact because of the relatively high value of these assets on CP entities' balance sheets. Impairments of brands and goodwill, therefore, can be a significant performance driver.

In 2010, 7 CP entities (10 in 2009) recognised an impairment loss on goodwill, although the value of the losses was low. The impairment amounted to around 1% of the goodwill recognised at year-end.

Nine entities surveyed recognised an impairment of brands. All impairments are around 1% of brand value at year-end (with the exception of **BAT**, which recognised a slightly higher loss of 6%), reflecting the continued strength of the brands in these entities. The majority of entities are optimistic, applying positive growth rates in their value-in-use calculations of goodwill and brands.

Within their annual reports, the surveyed CP entities generally do not specify the likelihood of possible future impairments should the economic environment continue to deteriorate.

Not all brands and trademarks have an indefinite life

Almost all entities in the survey recognised brands and trademarks with an indefinite useful life in their financial statements.

Applying an indefinite life is often related to the company's efforts to support the brand in terms of marketing.

For example, **Reckitt Benckiser** states:

"Applying indefinite lives to certain acquired brands is appropriate due to the stable long-term nature of the business and the enduring nature of the brands. A core element of the Group's strategy is to invest in building its brands through an ongoing programme of product innovation and sustained and rising marketing (particularly media) investment."

Reckitt Benckiser PLC, Annual Report 2010, page 35

AB InBev identifies marketing as an indispensable factor in the indefinite life of a brand:

"Brands are considered to have an indefinite life unless plans exist to discontinue the brand. Discontinuance of a brand can be either through sale or termination of marketing support."

AB InBev, Annual Report 2010, page 73

For brands and trademarks with a finite useful life, the CP entities surveyed used a range from 5 to 60 years, reflecting the unique nature of these assets and the need to consider the facts and circumstances in each case.

Matching goodwill and brands with cash-generating units

For the purpose of impairment testing, goodwill is allocated to each of the entity's cash-generating units or groups of units that are expected to benefit from the synergies of the combination. Each unit or group of units cannot be larger than a segment determined in accordance with the applicable standard for segment reporting, i.e., IFRS 8.

In our survey, the majority of CP entities identified cash-generating units for goodwill at, or one level below, the segment level.

Almost all CP entities own at least one brand or trademark with an indefinite useful life. In many cases, single brands or



groups of brands are defined as a cash-generating unit (CGU), as the management and reporting system is based on the brand structure. Impairment testing for brands is, however, regularly performed one level below, at the level of the individual brand. In very limited cases, brands and trademarks are allocated to different CGUs than goodwill.

“A Cash-Generating Unit corresponds to one or more worldwide brands. A Cash-Generating Unit can contain several brands depending on organisational criteria and particularly when distribution circuits and commercial/management structures are pooled.”

L'Oréal, Annual Report 2010, page 13

Putting a value on brands and trademarks

For impairment testing purposes, an entity must determine the recoverable amount of brands and trademarks, which is defined as the higher of either fair value less cost to sell or the value in use.

The fair value less cost to sell should primarily be determined based on market transactions. If market transactions are not observable (because brands and trademarks are not traded in a market), the fair value less cost to sell has to be determined using valuation techniques. The value in use, however, has to be determined based on a discounted cash flow approach.

CP entities use a variety of valuation techniques to calculate the fair value less cost to sell or the value in use. However, the majority of entities use one of the following two models:

- ▶ Relief from royalty method
- ▶ Discounted cash flow method

Using the relief from royalty method requires estimating the hypothetical costs the entity would avoid by owning the brand or trademark rather than licensing it from another party in an “arm’s length” transaction. This technique allows the individual valuation of single brands. However, it requires a comparatively high degree of data analysis and estimation.

The discounted cash flow method is used to calculate the value of an entire CGU or a group of CGUs including all the brand assets. The value is then allocated to the different assets based on the requirements of accounting standard IAS 36.

The basis for determining present value is a cash flow projection based on the most recent financial forecast, and budgets approved by management.

The entities in our survey based their cash flow projections on detailed forecast periods ranging from 1 to 20 years.

The cash flow projections beyond the most recent budget, until the end of an asset’s useful life, are estimated by extrapolating cash flows based on the financial forecasts using a growth rate for subsequent years. IAS 36 requires that the growth rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry life cycle.

The valuation models used – although generally comparable in methodological terms – vary widely in their assumptions. Some entities use a limited number of forecast periods together with a fixed growth rate for terminal value calculations. Others differentiate between a detailed forecast period, a mid-term forecast period and a terminal value analysis using different growth rate assumptions for each period. Some entities forecast revenue growth rates with a constant margin; others also forecast efficiency enhancements by increasing expected margins.

In comparing the valuation techniques, major differences are also encountered due to the different geographical areas in which entities operate, as discount rates and growth rates can vary significantly depending on the countries in which the CGU generates cash flows.

We could not, therefore, derive any sector-specific assumptions and estimates used as key parameters for impairment testing by CP entities.

Cut your cloth to suit your needs

Generally speaking, however, growth rates applied by the majority of surveyed entities are between 0% and 3%, occasionally rising as high as 5%. However, four of the entities have assumed higher long-term sustainable growth rates, but these growth rates related to certain regions.

Unilever uses 8% to 9% for the regional Savoury and Dressings CGU Asia, Africa and Central and Eastern Europe (Unilever, Annual Report, page 88). **Diageo** assumes 8.4% and 30.3% for brands and other intangible assets that generate cash flows in Russia/Eastern Europe and International – Venezuela, respectively (Diageo, Annual Report, page 135). **Nestlé** assumes sales growth between 3.0% and 8.0% for its two main CGUs (Nestlé, Annual Report, page 75). **SABMiller** uses long-term growth rates of 7.0% and 7.5% for the group’s operating segments in Asia and Africa, respectively (SABMiller, Annual Report, page 105).



The following statement and indicative ranges of discount rates and growth rates may provide insight into the variety of approaches taken:

“The following key assumptions were used in the discounted cash flow projections for the regional Savoury, Dressings and Spreads CGUs:

- ▶ A longer-term sustainable growth rate of 2% to 3% for Western Europe, 3% to 5% for The Americas and 8% to 9% for Asia Africa CEE
- ▶ Average near-term nominal growth rates for the major product groups within the CGUs of 2% Western Europe, 4% The Americas, 10% for Asia Africa CEE
- ▶ Average operating margins for the major product groups within the CGUs ranging from 18% to 21% Western Europe, 17% to 23% The Americas and 10% to 14 % Asia Africa CEE.

The growth rates and margins used to estimate future performance are based on past performance and our experience of growth rates and margins achievable in our key markets.”

Unilever, Annual Report 2010, page 88

The majority of participants in our survey disclosed a pre-tax discount rate recognising that valuations are regularly made at an international level, involving more than one taxation regime. Only some presented a post-tax rate. The disclosed pre-tax rates ranged from 5.3% to above 25%, depending mainly on geographical area or product group (Diageo, for example, applies a pre-tax discount rate of 74% for its Venezuela business - **Diageo**, Annual Report, page 135).

Discount rates are primarily estimated using the weighted-average cost of capital (WACC) of the entity. The estimation of the components is often not presented.

Sensitivity analysis offers route towards greater comparability

The majority of surveyed CP entities have provided sensitivity analyses, but mostly in very short statements. The statement of **Heineken N.V.** is representative of the majority of entities included in the survey:

“The outcome of a sensitivity analysis of a 100 basis points adverse change in key assumptions (lower growth rates or higher discount rates respectively) did not result in a materially different outcome of the impairment test.”

Heineken, Annual Report 2010, page 98.

Some entities do provide more detailed information. **Danone**, for example, states:

“As of December 31, 2010, a sensitivity analysis of the value in use within the three groups of CGUs (Baby Nutrition Asia, Baby Nutrition Rest of the World and Medical Nutrition) shows the following impacts:

- ▶ A 0.5% increase in the discount rate would lower the aggregate recoverable value of the three CGUs by €1.6 billion [...]
- ▶ A 0.5% decrease in the long-term growth rate would lower the aggregate recoverable value of the three CGUs by €1.3 billion; the recoverable value of each CGU would continue to exceed the carrying amount [...]
- ▶ A 100-basis-point reduction in the margin would lower the aggregate recoverable value of the three CGUs by €0.9 billion.”

Danone, Annual Report 2010, page 75

This latter example shows how possible future risks associated with intangible assets can be estimated. If similar statements appeared in more annual reports, this might increase the comparability of entities reporting goodwill.

Impairment and the income statement

The presentation of impairment losses in the income statement is not specified under IFRS, and hence, in the CP industry, there are diverse approaches to presentation. The guidance given in IAS 1, *Presentation of Financial Statements*, is limited to the prohibition of extraordinary items and the requirement for certain items to be shown, although the order and description of these items requires management judgement. IAS 1 also requires additional items to be presented where such presentation is relevant to an understanding of the entity's financial performance.

A number of the CP entities in our survey included impairment losses for goodwill and brands within operating profit. However, others presented impairment losses as non-trading, non-operating, non-recurring or as an exceptional item.

Some CP entities present goodwill and brand impairment losses separately, either in a separate income statement line item, or as additional disclosures in the notes to the financial statements.

In August 2010, IASB and FASB issued Leases – a joint ED. In July this year, the Boards decided to re-expose the ED for a second time following rigorous re-deliberations and significant changes made to the proposals in the original ED. The issuance of the final standard is expected to be delayed until 2012, and all decisions so far are tentative. However, there is a high degree of certainty that some proposals from the ED will be implemented, including a single model that would virtually reduce off-balance sheet financing through operating leases. Under the proposals, the standard would affect existing leases at transition, and no leases would be grandfathered.

Background

The proposed changes address some of the more frequent criticisms of the current model, including:

- ▶ Economically similar lease transactions may be treated differently for accounting purposes
- ▶ Material assets and obligations arising from operating leases are not recorded
- ▶ Estimates at inception of a lease are not reassessed

The proposed model would require most leases to be recognised on the balance sheet and would also require entities to make a number of estimates and periodically reassess those for

accounting purposes. The impact of the proposals on businesses and on the financial statements could be significant, including:

- ▶ An increase in assets resulting in lower asset turnover ratios
- ▶ An increase in current and non-current liabilities and an increase in the debt-to-equity ratio
- ▶ Changes to key income statement metrics, including, for example, net income and EBITDA
- ▶ Higher amortisation and interest expenses instead of rent expenses
- ▶ Constant amortisation and declining interest expense over the anticipated lease term, leading to an initially lower profit

These changes may also affect companies' decisions whether to lease or buy significant assets.

Key findings

Brands and goodwill represent significant economic value for CP entities – in some instances, they amount to more than half of total assets.

For impairment testing purposes, goodwill is usually allocated to CGUs at or one level below a segment level. In many cases, the CGUs are defined by the brand structure and are used for both brand and goodwill impairment testing.

The majority of CP entities apply either the relief-from-royalty method or a discounted cash flow method to value brands for the purpose of impairment testing. However, there is diversity in practice regarding the parameters used.

Interest rates and growth rates are generally not comparable, as they are mostly determined individually depending on the business and geographical risks. Although desirable, detailed sensitivity analyses are not provided by a wide range of entities.

Some CP entities in our survey included impairment losses arising from goodwill and brands within operating profit. Others, however, presented impairment losses separately as non-trading, non-operating, and non-recurring or as an exceptional item. Others split amortisation and impairments by function and subsume the losses within the functional headings.



Leases: proposed new model to have significant impact for some CP entities

Most CP entities are lessees, rather than lessors, typically having lease agreements for offices, stores or production premises.

As such, under the current proposal for lessee accounting, assets and liabilities arising under nearly all these arrangements will have to be recognised. For all leases, lessees will have to recognise a liability to make lease payments and so create a right-of-use asset.

Companies will need to take account of a number of key requirements if the ED is put into effect, as outlined below.

The liability to make lease payments would initially be measured at the present value of lease payments over the lease term.

The lease term is defined as the non-cancellable period plus any options where there is a significant economic incentive to extend or not terminate the lease, such as penalty payments for cancellation or non-renewal. This definition expands the period of time under current IAS 17 but typically shortens the "longest more-likely-than-not" lease term under the original ED.

Lease payments would include all unavoidable payments, such as fixed lease payments, residual value guarantees, exercise prices of purchase options or termination option penalties.

Contingent rentals, on the other hand, are expensed as incurred if they are truly variable, i.e., solely based on performance or usage (e.g., a minimum interest rate would not qualify for a contingent rental).

The discount rate to determine the present value of lease payments would be the rate implicit in the lease when available, otherwise the lessee's incremental borrowing rate.

The right-of-use asset would be measured initially at cost and would include the amount of the liability to make lease payments plus any initial direct costs, such as commissions or legal fees incurred by the lessee. The asset will generally be amortised using the straight-line method, while interest expenses are recognised using the effective interest method. The resulting expense recognition pattern is consistent with the treatment of finance leases under current lease accounting.

If the key assumptions change, the right-of-use assets will need to be revalued, meaning that companies would need to develop processes and related controls for reassessment throughout the life of the lease.

In addition, right-of-use assets would be subject to impairment testing under IAS 36.

Impact on financial statements: a simulation

The proposed new lease model will alter balance sheet and income statement metrics in various ways. While the on-balance sheet approach will increase liabilities and non-current assets, it will also impact equity.

Liabilities – are increased by the present value of minimum lease payments at the inception of the lease. The amortisation during the lease term follows the effective interest method.

Non-current assets – are increased by an amount corresponding to the lease liability at the inception of the lease. The asset will be measured using straight-line depreciation during the lease in the majority of cases.

Equity – is affected due to the diverging measurement concepts of liability and asset. Generally, the liability will exceed the asset during the lease term, resulting in lower equity levels.

The proposed lease accounting method will alter key figures as follows:

| | |
|-------------------|--|
| <i>EBITDA</i> | + lease expenses |
| <i>EBIT</i> | + lease expenses - asset depreciation |
| <i>Net income</i> | + lease expenses - asset depreciation - effective interest |

EBITDA will no longer be affected by leasing expenditures. EBIT will also increase in part, as the interest rate part of expenditures will now be shown as interest expenses. Overall net income in aggregate should not be affected. However, as the on-balance sheet approach results in a non-linear recognition of expenses over the lease term, net income might be affected during periods of expanding or consolidating the lease contract portfolio.

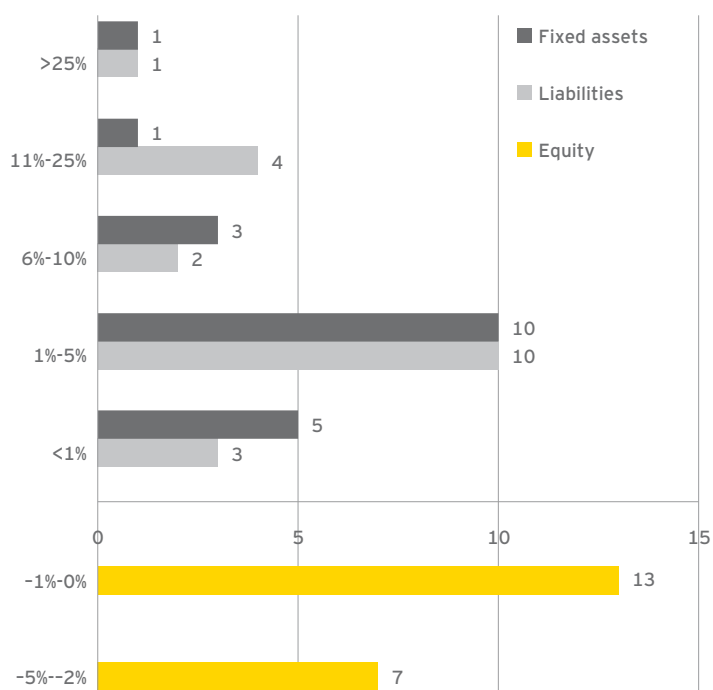
For each of the CP entities surveyed, we have prepared an approximation of the balance sheet under the new proposals, based on the published disclosures of the future minimum lease payments on operating leases in the annual report. We have used a discount rate of 7%, and lease payments and duration have been assumed as constant from the second year onwards. The fixed assets can be calculated because of the functional connection with the liabilities and equity can be measured as the difference between adjusted fixed assets and liabilities.

For our analysis of all the entities except **maxingvest**, **Henkel** and **FrieslandCampina**, we have used the EBIT and EBITDA values as well as interest expenses calculated and published by OneSource Information Services, Inc., in July 2011. For these three companies, we have calculated the values based on the disclosures in their annual reports.

Due to the simplified assumptions we have made, this analysis provides only a rough indication of the potential impact of the new proposals. It does not consider any purchase or lease renewal options. Due to these limitations, the potential effect of the proposals may be significantly larger than indicated below.

The changes to balance sheet liabilities, if all off-balance lease liabilities are capitalised, differ widely:

Impact on balance sheet metrics



While about two thirds of entities surveyed need not expect an impact greater than 5% on their recognised fixed assets and liabilities, five entities will suffer an increase in recognised liabilities of more than 10%, with a corresponding increase in fixed assets.

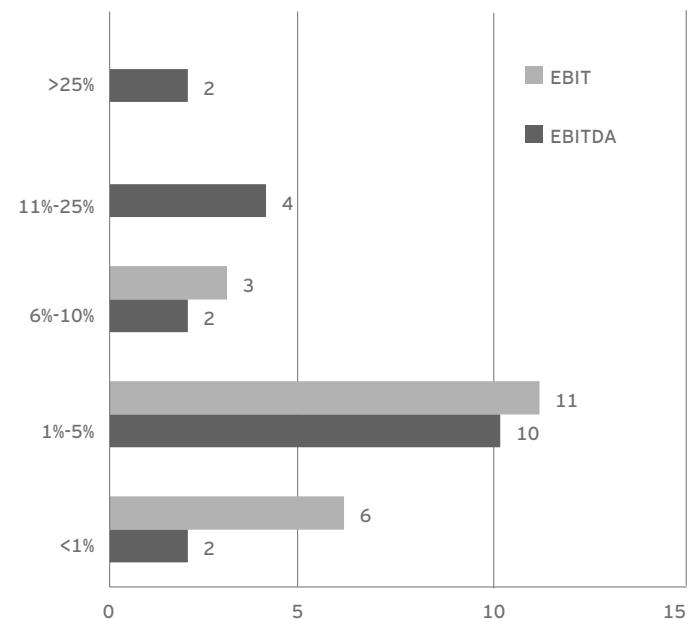
The maximum increase estimated across all 20 entities is 27% in fixed assets and 31% in liabilities. However, the reduction of equity is expected to be significantly lower, averaging around 1%.

The impact on the income statement is likely to be much more varied across the companies surveyed. Interest expense increases start at less than 1% and peak at more than 220%, with a median of 7.5%.

EBITDA and EBIT might, in some cases, also go through significant changes, with six entities likely to see an increase in EBITDA of more than 10%, including two with more than 25%. Due to the requirement to depreciate and amortise lease assets, EBIT is less affected, with the two entities mentioned above expected to see an increase of slightly less than 10%.

In total, based on our assumptions, net income change (EBIT + interest expenses) will range from €2m to €14m across the 20 surveyed entities.

Impact on EBITDA and EBIT



Luxury and apparel sector entities will be particularly affected, since they are often lessees of a high number of retail stores. Effects on the beverage and tobacco industry, on the other hand, are likely to be minor. There is a trend towards greater control over the products value chain, but the proposed leasing model may impose challenges for companies whose model requires leasing.

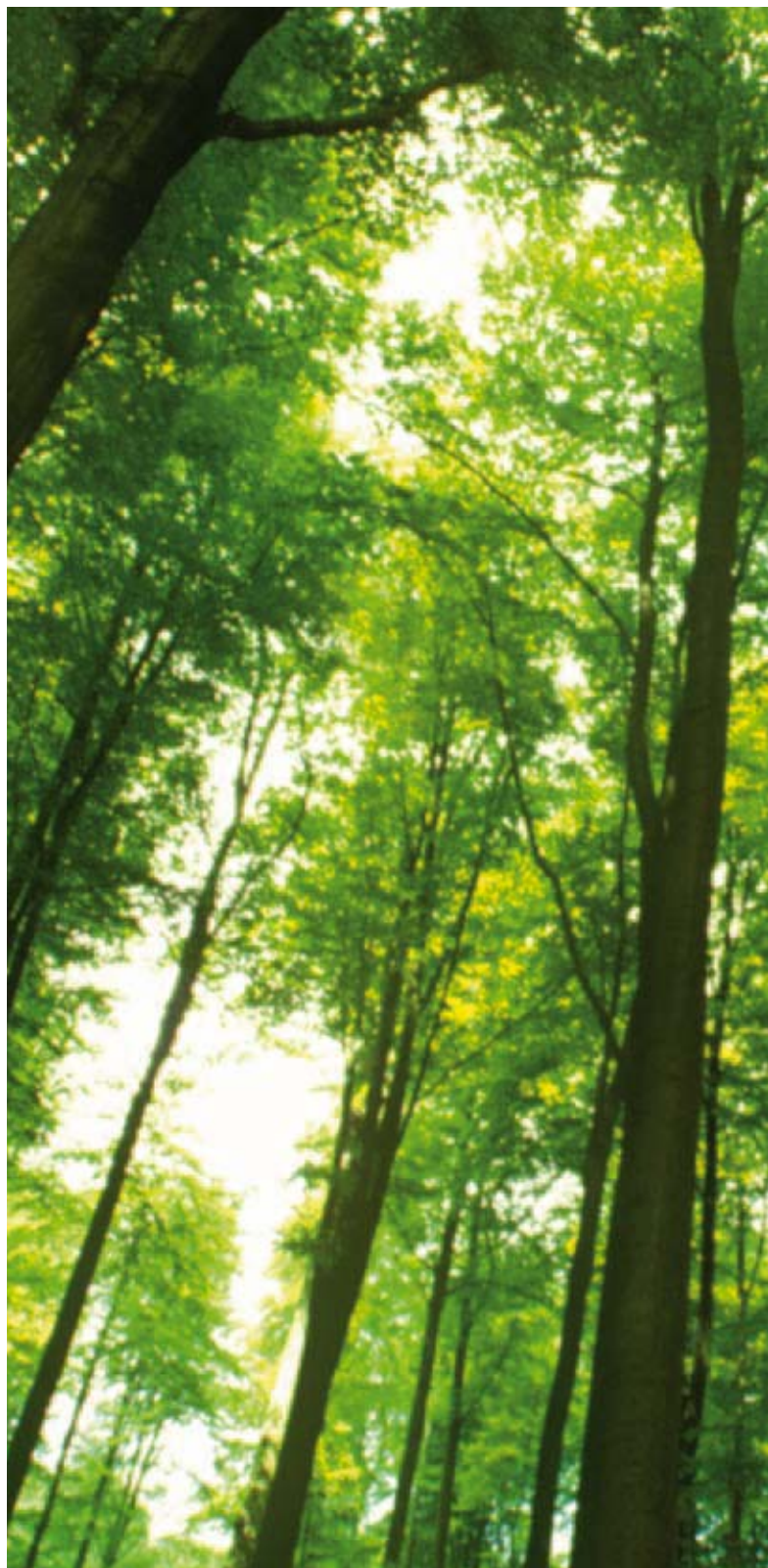
In preparation for the new lease accounting model, entities might consider the likely impact on contractual arrangements. Financial debt covenants, as well as contractually agreed profit distribution agreements, might depend on balance sheet or income statement amounts that have been significantly altered by the new accounting. Adjusting contractual agreements by deciding on a consensus with counterparties could help avoid surprises. Entities that are likely to be significantly affected may also wish to consider whether there are changes to their lease arrangements that should be made in order to mitigate the potential impact of the proposals.

Key findings

Although the issuance of a final standard will be delayed until 2012, off-balance sheet reporting for operating leases will be virtually eliminated.

The proposal will significantly impact lease expense recognition and balance sheet metrics.

Entities from the luxury and apparel sector, including cosmetics manufacturers, are likely to suffer significant changes.





Hedge accounting: reducing complexity under IFRS 9

Hedge accounting and accounting for derivative financial instruments are often considered the most complex topics within IFRS. Some of the entities in our survey do not apply hedge accounting to all hedging relationships, because some of the criteria in IAS 39 *Financial Instruments: Recognition and Measurement* are not met.

With the issuance of the ED for the third instalment of the new standard IFRS 9 *Financial Instruments*, which replaces IAS 39, some of the prohibitive rules will be simplified so that more items will qualify for hedging.

Phase 3 of IFRS 9 covering hedge accounting has not yet been issued by the IASB, the surveyed entities have not yet assessed the possible impact of this part of the new standard. Nevertheless, with regards to hedge accounting, CP entities will need to review their current economic hedging activity in order to identify new opportunities and revisit their risk management objectives and strategies.

In the following sections, we describe the implications of the changes to the current hedge accounting standard proposed by the ED that will affect some of CP entities.

Risk management

IAS 39 does not provide an objective for hedge accounting, but instead presents various rules and restrictions as to the circumstances under which hedge accounting can be applied. In contrast, the ED introduces an objective for hedge accounting which is described as “representing in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss.”

As in IAS 39, formal designation and documentation of the hedging relationship, the entity’s risk management objective and strategy will still be required.

Entities such as **adidas** may be able to re-assess the use of hedge accounting under the new requirements even though, under current rules, they have not met the requirements to apply hedge accounting. Adidas’ reason for not applying hedge accounting was:

“Certain derivative transactions, while providing effective economic hedges under the Group’s risk management policies may not qualify for hedge accounting under the specific rules of IAS 39. Changes in the fair value of any derivative instruments that do not qualify for hedge accounting under IAS 39 are recognised immediately in the income statement.”

adidas, Annual Report 2010, page 191

Hedged items

Items that were eligible for hedge accounting under IAS 39 will continue to be eligible under the ED’s proposals.

However, many entities have not been able to apply hedge accounting for risk components of non-financial items, as those can only be designated for its foreign currency risk component or all its risks in their entirety. Therefore, the change introduced by the ED, to permit a broader range of risk components of non-financial items that are eligible for hedge accounting, will possibly enable entities in the CP sector to apply hedge accounting.

Hedging instruments

The ED proposes to relax some of the restrictions on the types of instruments that can qualify as hedging instruments for hedge accounting purposes. CP entities will need to assess the impact on their current hedging portfolio.

CP entities often use dollar-traded commodities in their production processes or acquire other goods in foreign currencies. Interest rate exposures also arise from different financing strategies. Consequently, most entities use hedging policies to mitigate currency and interest rate risk.

The financial instruments used are often tailored to respective risks, and include but are not limited to currency swaps, cross currency interest rate swaps, swaptions, caps and collars. Credit default swaps are not generally used to hedge credit risks.



Effectiveness assessment

The objective of the hedge effectiveness assessment under the old and new guidance is to “ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness.”

Under the ED, hedge effectiveness will have to be assessed prospectively at inception and prospectively every reporting period on an ongoing basis. In contrast, IAS 39 requires an additional effectiveness assessment on a retrospective basis.

The currently required bright-line test of 80% to 125% for hedge-effectiveness testing will be eliminated, and there will be no target level for applying hedge accounting.

As there is only limited guidance in IAS 39 on how to test hedge effectiveness, various methods of assessment have developed in practice. The appropriateness of a given method depends on the nature of the risk being hedged and the type of hedging instrument used. Only two entities mention the techniques used for the assessment of hedge effectiveness. These entities applied the following techniques: dollar offset method; critical terms match method; regression analysis; hypothetical derivative method; and volatility reduction method.

The ED does not specify a particular method for assessing whether a hedge relationship meets the hedge effectiveness requirement, hence, either a qualitative or quantitative approach might be appropriate.

In addition, changes to hedge relationships, such as those caused by changes in risk management objectives, may result in a rebalancing of the hedge ratio rather than de-designation under IAS 39.

No changes are planned for the measurement of ineffectiveness – it will continue to be measured on a retrospective basis and recognised in profit or loss.

Commodity risk management

CP entities are frequently subject to risks arising from commodity price volatility. Hence, a number of the entities surveyed actively manage commodity price risks as part of their hedging activities.

Commodity price risks can be potentially reduce in a number of ways. Long-term supplier contracts, futures, purchase options and similar derivative instruments, as well as commodity financing agreements can be used to reduce the impact of price volatility.

Some of these arrangements are outside the scope of IAS 39 - for example, commodity contracts that will be settled by physical delivery and are for the entity's own use. The majority of entities managing commodity price risk use arrangements within the scope of IAS 39. Some entities explicitly describe the usage of the “own use exemption” for selected derivative financial instruments.

Unilever describes its commodity risk management as follows:

“The Group uses commodity forward contracts and futures to hedge against price risk in certain commodities. All commodity forward contracts and futures hedge future purchases of raw materials. Settlement of these contracts will be in cash or by physical delivery. Those contracts that will be settled in cash are reported in the balance sheet at fair value and, to the extent that they are considered as an effective hedge under IAS 39, fair value movements are recognised in the cash flow reserve.”

Unilever, Annual Report 2010, page 103

In its ED, the Board proposes that derivative accounting would apply to contracts that would otherwise meet the “own use” scope exception, if an entity's risk management strategy is fair value based. However, since the ED only includes a summary of the proposed changes rather than the detailed requirements of the changes, it is not yet possible to assess the impact of the proposals fully.

Embedded derivatives

Commodity risk management often requires accounting for embedded derivatives. An embedded derivative is a part of a host contract, whose cash flows are influenced by the actual host contract as well as the derivative portion that behaves in a similar fashion to a stand-alone contract. A long-term purchase contract for commodities denominated in a foreign currency is, for example, the combination of a long-term purchase contract and a currency forward contract.

Unilever states:

“In accordance with IAS 39 ‘Financial Instruments and Measurement,’ Unilever has reviewed all contracts for embedded derivatives that are required to be separately accounted for if they do not meet specific requirements set out in the standard; no material embedded derivatives have been identified.”

Unilever, Annual Report 2010, page 101

Embedded derivatives must be accounted for separately if the economic characteristics and risk of the derivative are not closely related to the host contract and the host contract is not measured at fair value.



IAS 39 provides official guidance on this issue. SABMiller explains its policy as follows:

“Such embedded derivatives need not be accounted for separately if the host contract is already fair valued; if it is not considered as a derivative if it was freestanding; or if it can be demonstrated that it is closely related to the host contract. There are certain currency exemptions which the group has applied to these rules which limit the need to account for certain potential embedded foreign exchange derivatives. These are: if a contract is denominated in the functional currency of either party; where that currency is commonly used in international trade of the good traded; or if it is commonly used for local transactions in an economic environment.”

SABMiller, Annual Report 2010/2011, page 88

IFRS 9 abolishes the separation of embedded derivatives from financial assets required by IAS 39, meaning that embedded derivatives that were not closely related to the financial host asset will no longer be separated. Financial liabilities as well as hosts not within the scope of the standard (e.g., leasing contracts, insurance contracts, contracts for the purchase or sale of non-financial items) continue to be covered by the embedded derivative concept of IAS 39, which is now included in IFRS 9.

Key findings

All entities apply hedging strategies to reduce their interest rate risks and foreign currency exchange risks. Some entities also engage in hedging commodity price risks.

Although all the entities in our survey are involved in some economic hedging, not all entities apply hedge accounting, due to either the strict requirements of IAS 39 or to the administrative burden of hedge accounting and documentation requirements. The proposed changes by IFRS 9 will enable some entities to apply hedge accounting to more hedged items.

Those entities applying hedge accounting currently present comprehensive information about the types of risks hedged and the instruments used for hedging.

A number of entities also present information about derivative financial instruments used in hedging commodity price risks.

Only a few CP entities provide information on accounting for embedded derivatives, and even fewer present details about the testing of hedge effectiveness.



Financial instruments: assessing fair value and sensitivity to meet IFRS 7

IFRS 7 *Financial Instruments: Disclosures* requires entities to make disclosures about the significance of financial instruments to the entity's financial position and performance, and the nature and extent of risks arising from those financial instruments.

IFRS 7 requires that the classification of financial instruments at fair value be determined by reference to the source of inputs used to derive that fair value. This classification uses the following three-level hierarchy:

Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices)

Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs)

Finding the right level

Clearly, the classification of financial instruments within this hierarchy requires professional judgement.

The disclosures about the significance of financial instruments include the presentation of fair values for all financial instruments. The disclosures describing the nature and extent of risks include identification of the major risks and their description, and a detailed quantitative analysis of their impact on the financial statements.

The risk factors identified by all entities include foreign exchange risk, liquidity risk, credit risk, and interest rate risk. Equity risks and commodity pricing risks are identified on a less regular basis, although a slight increase in disclosures compared with the prior year can be observed.

Frequency of risk factors considered

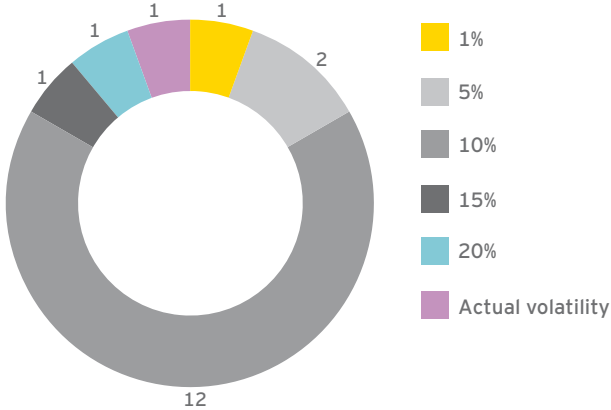


The need for sensitivity

Those entities that identify foreign exchange risk and interest rate risk all include a quantitative analysis. IFRS 7 requires entities to present a sensitivity analysis for each type of market risk they are exposed to. A Value-at-Risk (VaR) analysis may be presented instead of a sensitivity analysis.

In our survey, two entities, **Henkel** and **Nestlé**, present a VaR analysis for selected risk factors. All other entities present a sensitivity analysis. VaR typically uses individualised risk parameters and reflects interactions. Sensitivity analysis allows the individual assessment of risk factors under chosen variations.

Variations used for foreign exchange risk sensitivity analysis



The majority of entities use a 10% variation as an approximation for foreign exchange volatility, although one entity used actual volatilities instead. (The entities using the VaR method are not included in the graphic.)

The observable one-year volatilities of the exchange rates between GBP, USD and YEN with respect to the EUR in 2010 were between 2.9% and 6.1% of the average exchange rate during the calendar year 2010.

Most entities apply sensitivity analysis for interest rate risk, while Nestlé presents a VaR analysis. In 2010, only one entity used actual volatilities, six entities used a 50 basis point (BP) variation and all other entities used a 100 BP variation as an approximation of interest rate volatility.

Own-equity risk is regularly mentioned as a significant risk factor. However, only five entities provide quantitative analysis. The variations in parameters used for sensitivity analysis range from 1% to about 35%.

Surprising lack of quantitative commodity risk analysis

Some entities refer to long-term purchase contracts and the related reduced exposure to price variations, but only five entities (three more than 2009) present quantitative analysis for commodity risks. This result is perhaps surprising, as commodity price risk is a major risk for many CP entities.

SCA presents the following information regarding the impact of energy price volatility:

“If energy prices had increased/decreased by 20%, outstanding financial hedges relating to natural gas and electricity, all other things being equal, would have decreased/increased energy costs for the year by SEK235m [...]. In addition to the earnings impact, equity would have increased/decreased by SEK144m. [...] The total energy cost for the Group, however, would have been affected differently, if the price risk related to supply contracts was taken into account.”

SCA, Annual Report 2010, page 82

Key findings

Almost all entities disclose foreign exchange risk, interest rate risk, liquidity risk and credit risk as significant risk factors. Only some entities present equity risks and commodity price risks as significant risk factors.

Quantitative data is generally presented using a sensitivity analysis, although two entities surveyed have used a VaR analysis.

Variations used for sensitivity analysis are regularly compared to observable market volatilities. A variation of 50 or 100 BP has developed as an implicit reporting standard for interest rate risks. Variations regarding equity prices and foreign exchange risks are less uniform amongst the entities surveyed.

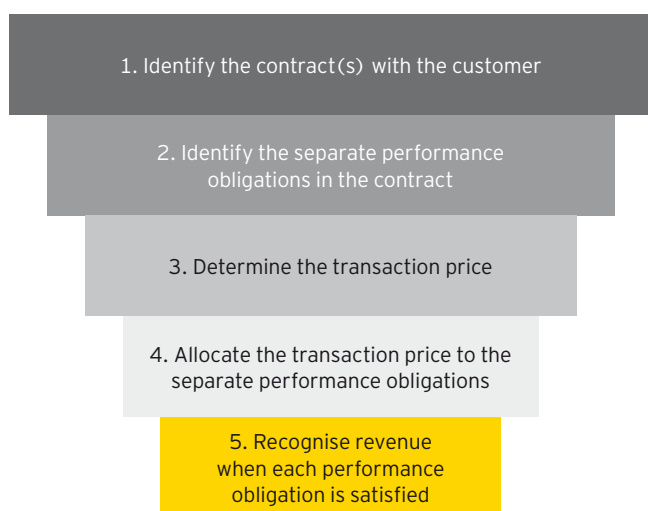


The revenue recognition project: key impacts on CP entities

The original exposure draft issued by the Boards in June 2010 went through extensive public consultation, and the Boards have now completed re-deliberations on the proposals in the ED. We are now anticipating the issue of the second exposure draft in the next month or two, following the Boards' decision to re-expose the proposals, some of which have changed significantly from the original ED.

The model

The proposed model includes five steps that entities would apply to determine the appropriate amount and timing of revenue recognition:



The Boards are proposing that entities apply the new guidance retrospectively for all periods presented in the period of adoption, although the original ED did not include a proposed effective date.

Step 1: Identify the contract with the customer

The model requires CP entities to identify contracts and counterparties, unbundle multiple-element contracts with more than one performance obligation and combine contracts that are inherently linked.

Step 2: Identify the separate performance obligations

In cases where an entity promises to provide a bundle of goods or services that are inseparable, it should account for them as a single performance obligation.

This would be the case where the goods or services are highly interrelated and the entity has to integrate them under the terms of the contract. Under the proposed model, the entity has to identify all performance obligations included in the contract, for example, splitting warranties out from sales contracts.

Step 3: Determine the transaction price

The accounting model gives detailed guidance on determining the transaction price. While in most cases the transaction price is observable, in some instances, portions of the transaction price may be variable, e.g., discounts, rebates, refunds, credits, incentives, bonuses/penalties, contingencies or concessions.

Consequently, entities will have to develop models for determining transaction prices based on reasonable estimates using the "probability-weighted amount" or "the most likely amount".

Step 4: Allocate transaction price to the separate performance obligations

Once the performance obligations are identified and the transaction price is determined, the proposed model requires an entity to allocate the transaction price to the performance obligations in proportion to their relative stand-alone selling prices.

Step 5: Recognition of revenue as each performance obligation is satisfied

The proposed model states that revenue allocated to a particular performance obligation should be recognised at the point the customer obtains control of the underlying good or service. A customer obtains control of a good or service when the customer has the present ability to direct the use of, and receive the benefit from, the good or service.

Expected impact on CP industry

Sales incentives and vendor allowances

Various types of sales incentives and vendor allowances are common in the CP industry. CP entities provide retailers or other customers with different forms of vendor allowances, such as volume discounts, slotting fees, advertising or promotional allowances.

If the consideration payable to the customer is for payment for a distinct good or service, the CP entity would be able to account for the payments as an expense. Some entities have recently amended their accounting policies to recognise promotional costs as a deduction from revenue.

In our survey, **maxingvest** provides a clear statement about the application of the new guidance:

“Under IFRS, there are as yet no concrete requirements on how to present expenses for consideration payable to trading partners for services supplied. [...] The Beiersdorf and Tchibo sub-groups will voluntarily change the policy for accounting for these expenses. Effective 1 January 2011, expenses for consideration payable to trading partners will no longer be presented in marketing and selling expenses, but will rather be deducted from sales revenues in those cases where the consideration is not matched by a distinct good or service supplied whose fair value can be estimated reliably. “

maxingvest, Annual Report 2010, page 53

Also, **Nestlé** announced the upcoming change:

“Certain allowances and discounts, granted to trade chains, customers, retailers and consumers for trade and consumer promotions, selling, distribution, advertising and other services, rendered to the Group are currently treated as expenses under marketing and administration expenses as well as distribution expenses on grounds that they are incurred to generate revenue. The Group will treat these allowances and discounts as from 2011 as a deduction of revenue in conformity with the practice generally admitted by consumer goods companies. Based on 2010 figures, the reclassification from distribution expenses as well as marketing and administration expenses to sales amounts to CHF16, 707 million.”

Nestlé, Annual Report 2010, page 60

Analysts welcome the early adoption of the new regulation, as it gives a more comparable picture of sales.

Product warranties

Product warranties are commonly included in the sale of goods. These warranties may or may not reflect separate performance obligations, depending on the objectives of the warranty provided. The initial ED would have represented a significant change from current practice for CP entities providing warranty coverage for their products, as it would have resulted in an initial deferral of revenue, rather than just a provision for expected costs.

During the re-deliberation phase, the Boards tentatively decided that if the warranty provides assurance to the customer that the delivered product is as specified in the contract, companies should treat it as a provision. Only those warranties that provide a service to the customer, in addition to the assurance, should be treated as a separate performance obligation.

Licences and other rights of use

Granting licenses and other rights of use is common for many companies in the CP industry. The Boards initially proposed to distinguish between exclusive and non-exclusive licences. The initial ED would have represented a significant change in current practice.

During the re-deliberations, the Boards decided not to differentiate based on exclusivity of the licences. Further, in a contract in which an entity grants a licence to a customer, the promised asset is the licence and the promise to grant that licence represents a single performance obligation. That obligation is satisfied only when the customer is able to use and benefit from the licence. If there are other performance obligations in the contract, an entity should consider whether the rights give rise to a separate performance obligation or whether the rights should be combined with those other performance obligations.

Classification of uncollectible amount

The Boards tentatively decided that all uncollectible amounts would now be recognised in the income statement in a separate line item that is presented next to revenue (as contra revenue), rather than presenting some amounts as a reduction of revenue and some amounts as part of other income or expense as originally proposed. This proposed requirement would reduce reported gross margins, as bad debt amounts are currently reported as an expense below gross margin.

Next steps

Although for many transactions common in the CP sector, the ED may not change the timing or amount of revenue recognition, there will be instances where this has an impact, particularly around product warranties, discounts and sales incentives.

The decision that the Boards made to re-expose the revenue recognition proposals at the June 2011 meeting, will give constituents another opportunity to comment on the proposals formally. We encourage CP entities to provide feedback to the Boards on the proposals.



Sustainability reporting: integrating non-financial information

A growing number of organisations across all industries report on sustainability issues, which helps readers to understand how well the reporting entity manages sustainability-related risks and opportunities in addition to their financial performance.

The trend towards greater disclosure, especially in the CP industry, is supported by the fact that consumers are becoming increasingly aware of the links between buying behaviour and social and environmental impact. Failure to report on sustainability may therefore increase risk – making companies appear less transparent than their competitors, harming reputation and negatively affecting product sales – whereas professional reporting may lead to greater stakeholder trust, deepen customer relationships and improve internal risk management.

In our survey of 20 European CP companies, all entities chose to produce a separate sustainability report and integrated selected sustainability information within their annual report. Since reporting is voluntary and the definition of a “sustainability report” is not fixed, the scope, contents and structure of the disclosed reports differ widely due to the different business environments in which entities operate.

However, an extensive sequence of non-financial information would not add value and comparability at the corporate level, nor at the stakeholder level. The lack of clearly stated reporting standards is bemoaned by some of the entities. **Heineken**, for example, points out:

“We would welcome the introduction of a global reporting standard that ensures the data and reporting of every organisation is independently assessed. It is the only way that accurate comparisons can be made and the most effective practices identified and quantified from which others can learn. It is also the best way to ensure the integrity of information and data for stakeholders.”

Heineken, Sustainability Report 2010, page 5

Nineteen of the surveyed entities make use of the “G3 Guidelines” reporting scheme issued by the GRI, which has become the established standard setter for large companies, and one entity applies the United Nations Global Compact Communication on Progress. All surveyed entities report on economic, environmental, labour, human rights, social impact, and product responsibility matters.

The GRI framework provides specific performance indicators, which the entities use to set objectives and measure their performance.

For example, **Danone** set the following environmental goals:

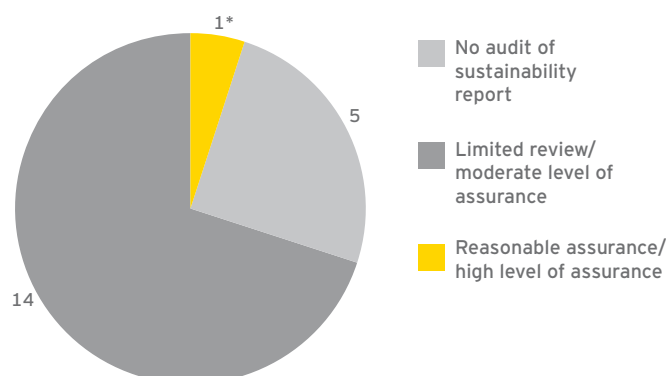
“Quantitative objectives were set for the entire group in 2001 for the 2000-2010 period (“lean plant” program): 20% reduction in energy consumption, 30% reduction in water consumption, 10% reduction in packaging weight, and 80% recovery of manufacturing waste.”

Danone, Sustainability Report 2010, page 157

While all of the surveyed entities reported on sustainability issues in their annual report, as well as in a separately published sustainability report, 15 of the entities provided additional assurance by having the sustainability reports audited by a third party. The scope of the audit reports differs in terms of topics covered and depth of audit.

Due to the application of different standards for assurance engagements such as ISAE 3000 and AA1000AS, the level of assurance is described differently. However, nearly all standards differentiate between a limited review and reasonable assurance. As shown in the chart below, the majority of entities let their sustainability reports undergo a limited or similar review, which generally means that the information is not believed to be materially misstated.

Frequency and type of sustainability report audits



*Assurance regarding certain environmental indicators



adidas points out that not all data in the sustainability report might be suitable for external auditing:

“We recognise that some stakeholders want companies to ensure that the content and data disclosed in sustainability reports is independently verified. While we strive to continuously improve our reporting systems for supplier monitoring data, we feel that much of this data – in particular, data on labour conditions – is not always verifiable in a standardised way. Therefore, at this stage, report verification would not add value. We do, however, believe that independent verification of workplace conditions and of the processes and monitoring approaches we adopt in our compliance programme is important. For this reason the report contains information that is subjected to an annual review by the Fair Labor Association. We also refer to data verified when supplier factories or our own facilities were certified to ISO, EM AS and OHSAS standards. In 2010, five major administration sites [...] were certified in accordance with the ISO 14001 environmental management standard. So any information disclosed about our environmental programmes at these sites has been subject to external auditing.”

adidas, Sustainability Report 2010, page 3

The trend towards an increase in the statutory obligation for sustainability reporting and, in some cases, integrated reporting can be observed worldwide. The European Union issued its EU Accounts Modernisation Directive in 2005, which is implemented in local laws and requires European companies to provide non-financial, environmental and social performance indicators in their business reviews.

There is currently no obligation under IFRS to integrate this information in the consolidated reports. Nevertheless, the biggest advantage of integrated reporting for companies would be more transparency, a better understanding and improved control of the relationship between financial and sustainability data.

The International Integrated Reporting Committee (IIRC) proposes in its framework that information on social, financial,

environmental and governance performance of companies shall be linked in a coherent, consistent and clear way to become comparable. A discussion draft will be announced for public consultation later in 2011.

“Integrated Reporting demonstrates the linkages between an organisation’s strategy, governance and financial performance and the social, environmental and economic context within which it operates. By reinforcing these connections, Integrated Reporting can help business to take more sustainable decisions and enable investors and other stakeholders to understand how an organization is really performing.”

IIRC (www.theiirc.com)

Key findings

Sustainability reporting is already being addressed by all CP entities, each of which uses a globally accepted framework.

However, there is still room for improving the linkage between financial information in the annual reports and the impact of sustainability issues through more integrated reporting and assurance from third parties.

The new consolidation, joint arrangements and disclosure accounting standards

In May 2011, the IASB issued three new standards: IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*. The new standards are supposed to provide more consistency and transparency in the accounting for and disclosure of relationships between entities. These new standards are effective for annual periods beginning on or after 1 January 2013.

In the following section, we shed some light on the possible impact on the CP entities in our survey with multiple global operations.

IFRS 10: a new definition of control

IFRS 10 does not change the principles on how to consolidate an entity but rather whether an entity is consolidated by introducing a new definition of control. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

The new definition of control applies to all entities, including special purpose entities (now called structured entities). There is no separate guidance for structured entities, since the issues raised in SIC-12 are now included in IFRS 10.

The new standard differs significantly from the current IFRS. Examples of their differences are:

- ▶ An investor can have control with less than a majority of the voting rights – this de facto control concept is now included in the standard.
- ▶ An investor can have control although he is formally not the holder of the voting rights (principal-agency relationships).
- ▶ An investor might have to consolidate a structured entity without being exposed to or having the rights to the majority of the risks and benefits (e.g., an entity having effective control, but not underlying the rights and obligations following the ownership of more than 50% of voting rights).
- ▶ An investor has to consider new guidance on whether potential voting rights provide control.

All entities should carefully investigate the possible impacts of IFRS 10. Entities that have numerous equity interests in other entities with slightly less than 50% of the voting rights might be impacted by IFRS 10.

However, based on our survey sample, we believe that CP entities

are unlikely to be much affected by the new guidance. Still, entities should assess their existing business structures and ensure that they are well prepared for a smooth transition to the new standard. The surveyed annual reports provide little or no information about unconsolidated companies (especially special purpose entities) that might be subject to the new definition of control.

IFRS 11: sweeping changes to accounting for joint arrangements

IFRS 11 introduces new guidance on accounting for joint arrangements. Every joint arrangement is either classified as a joint operation or a joint venture, depending on the rights and obligations of the parties to the arrangement. If the parties have rights to the assets, and obligations regarding the liabilities, the joint arrangement is a joint operation. If parties have rights to the net assets of the arrangement, it is a joint venture.

Arrangements classified as jointly controlled operations or jointly controlled assets under IAS 31 are now classified as joint operations. The accounting for these arrangements stays the same. In contrast, the accounting for jointly controlled entities (joint ventures under IFRS 11) has changed significantly. Jointly controlled entities, which are classified as joint ventures, are required to be accounted for using the equity method only. Proportionate consolidation is no longer an option.

Since many of the jointly controlled entities under IAS 31 accounted for using proportionate consolidation will be classified as joint ventures under IFRS 11, the transition can lead to significant changes to key financial statement performance measures. For instance, the entity's share of revenue from the joint venture is no longer within the revenue in the consolidated statement of comprehensive income, but part of the line item profit or loss of associates and joint ventures accounted for using the equity method. Since this line item is usually part of the financial result, the transition can lead to a decrease in EBITDA.

Nine of the 20 CP entities surveyed currently account for jointly controlled entities using proportionate consolidation. However, the overall impact of IFRS 11 may be negligible. Two CP entities report proportionate consolidated revenue that accounts for 5.4% and 3.1% respectively of the total revenue; in all other cases, the amounts are immaterial. It has been assumed that these arrangements will be equity accounted joint ventures under IFRS 11.

IFRS 12: the new comprehensive disclosure standard

IFRS 12 integrates disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities in a single IFRS to improve transparency of the relationship between entities and to avoid overlap between particular disclosures. Although many of the disclosure requirements were previously included in IAS 27, IAS 28 and IAS 31, those requirements in IFRS 12 are more expansive, and some are even new.

For instance, IFRS 12 requires an entity to disclose the significant judgements and assumptions it has made in determining whether it has control, joint control or significant influence over another entity. In addition, extensive disclosures for subsidiaries with non-controlling interests, joint arrangements and associates that are individually material will have to be made.

CP entities need to implement new or, at least, modify existing processes and systems to gather the information to comply with the new requirements of IFRS 12.

Key findings

All entities, regardless of industry, should carefully investigate the possible impact of IFRS 10. However, from information disclosed in the 2010 annual reports, CP entities are unlikely to be particularly affected by the new guidance. Likewise, the overall impact of IFRS 11 on CP entities may be negligible for some but significant for others, depending on their circumstances.

CP entities need to implement new processes or at least modify existing processes and systems to gather the information to comply with the new requirements of IFRS 12.



Appendix

Risks identified in the surveyed financial statements

| | Risk | adidas | Beiersdorf/ Tchibo | BAT | Christian Dior | Diageo | Groupe Danone | Heineken | Henkel |
|--|---|--------|-----------------------|-----|-------------------|--------|------------------|----------|--------|
| Financial risks | | | | | | | | | |
| Relate to volatility in markets and real economy | Rising and volatile input costs and other market risks | X | X | X | X | X | X | X | X |
| | Foreign exchange risk | X | X | X | X | X | X | X | X |
| | Interest rate risk | X | X | | X | X | X | | X |
| | Equity market risk | | | | X | | X | | |
| | Price volatility (commodities, raw materials, energy, wages) | X | X | | | X | X | X | X |
| | Liquidity risk | X | X | X | X | X | X | X | X |
| | Credit risk | X | X | | X | | | | X |
| | Counterparty risk | | X | | X | | X | | |
| | Seasonality | | | | | | X | | |
| | Pension obligations | | | | | | X | | X |
| Unfavourable change in business activity forecasts and its impact on impairment testing of assets (e.g., goodwill) | | | | | | | X | | |
| Compliance risks | | | | | | | | | |
| Relate to politics, law, regulation and corporate governance | Compliance and regulation | X | X | X | | X | X | X | X |
| | Regulation of labelling, distribution, advertising, environmental issues and health agenda | | | X | | X | X | X | |
| | Industry participation in regulation discussion | | | X | | | | X | |
| | Regulatory constraints on products, imports and exports, changes in taxes and duties | X | | X | | X | X | X | |
| | Legal risks (e.g., legal and contractual obligations, litigations directed at the industry and other litigation) | X | X | X | | X | X | X | X |
| | Difficulty of effecting service of US process and enforcing US legal process against directors located outside the US | | | | | X | | | |
| | Onerous disputed taxes, interest and penalties | | | X | | | | | |
| | Social acceptance and corporate social responsibility | X | | X | | X | X | X | |
| | Increased social and political attention to industry (environmental and health issues, ingredients, labour standards, sourcing) | X | | | | | X | X | X |
| | Environmental impact and climate change, unsustainable sourcing | | | X | | X | | | |
| Non-compliance with rules and standards that guide appropriate and responsible business behaviour | X | | | | | | | | |



| Imperial Tobacco Group | Anheuser-Busch InBev | L'Oreal | Nestlé | Pernod Ricard | PPR | Reckitt | Richemont | SABMiller | SCA | Friesland Campina | Unilever |
|------------------------|----------------------|---------|--------|---------------|-----|---------|-----------|-----------|-----|-------------------|----------|
| X | X | X | X | X | X | X | X | X | X | X | X |
| X | X | X | X | X | X | X | X | | X | X | X |
| X | X | X | X | X | X | | X | | X | X | X |
| | X | X | | | X | | X | | | | |
| | X | X | X | X | | | X | X | X | X | X |
| X | X | X | X | X | X | X | X | X | X | X | X |
| | X | X | X | | X | | X | | X | X | |
| | | X | X | | X | X | | | | | X |
| | X | X | X | X | | | | | | | X |
| | | X | X | X | | | | | | | |
| | | X | | | | | | | | | |
| X | X | X | X | X | X | X | | X | X | X | X |
| X | X | X | X | X | | X | | X | X | | X |
| X | | X | | | | | | | | | |
| X | X | X | X | X | | | | X | X | | X |
| X | X | X | X | X | X | | | | X | X | X |
| | | | | | | | | | | | |
| | | | | X | X | | | | | | X |
| | X | | X | X | X | X | | X | X | | X |
| | X | | X | X | | X | | X | | | X |
| | | | | X | | | | | X | | X |
| | | | | | X | | | | | | |

Appendix (cont'd)

Risks identified in the surveyed financial statements

| | Risk | adidas | Beiersdorf/ Tchibo | BAT | Christian Dior | Diageo | Groupe Danone | Heineken | Henkel |
|--|---|--------|-----------------------|-----|-------------------|--------|------------------|----------|--------|
| Strategic risks | | | | | | | | | |
| Relate to customers, competitors and investors | Retail power and private label growth | X | X | | | X | X | | X |
| | Customer consolidation, growth of discounters | X | X | | | X | X | | X |
| | Customers may limit brands or not actively promote brands, expand their own private label business | X | X | | | | X | | X |
| | Consumer dynamics and demographic shifts | X | | X | | X | X | X | X |
| | Recession and changes in consumer preferences | X | | X | | X | X | X | X |
| | Other economic, social and political uncertainties | X | | X | | X | X | | |
| | Emerging market strategy and execution/exposure to D&E markets | | X | X | | X | X | X | X |
| | Maintain good relationships with stakeholders and partners | | | | | | X | | |
| | Failure of M&A | | | | | X | X | X | X |
| | Failure to integrate acquisitions | | | | | X | X | X | X |
| | Failure to participate in transactions may inhibit ability to grow/exploit scale benefits | | | | | | X | | |
| | Missed or wrongly valued acquisitions | | | | | | | | |
| | Competitive intensity/industry consolidation | X | X | | | X | X | | X |
| | Recruiting, development and maintenance of talent | X | | X | | X | X | | X |
| | Ability to pursue successful strategies (including pricing), reorganisations | | | X | | | | X | |
| Own retail store risk | X | | | | | | | | |
| Operational risks | | | | | | | | | |
| Relate to processes, systems, people and overall value chain of a business | IT risks and security | X | X | X | X | X | X | X | X |
| | Supply chain agility and resilience | X | X | | X | X | X | X | X |
| | Supply shortages and increased prices | X | X | | X | X | X | X | X |
| | Inventory risks related to misjudging consumer demand | X | | | | | | | |
| | Failure to maintain/renew/negotiate distribution, supply, manufacturing, licence or marketing agreements/partnerships on favourable terms | X | | | | X | | | |
| | Brand and marketing effectiveness | X | X | X | X | X | X | X | |
| | Brand image and reputation | X | X | X | X | | X | X | |
| | Product quality and safety, ingredients, contamination | X | X | | | X | X | | |
| | Protection of intellectual/ industrial property rights, product counterfeiting, illicit trade | X | X | X | X | X | X | | |
| | Speed and success of innovation | X | X | | | X | X | | |
| | Continued product innovation, failure to ensure relevance, attractiveness of brands | X | X | | | X | X | | |
| | Failure to predict consumer's changing behaviour and demand | X | | | | | | | |
| | Internal control failure | | | | | | X | | |
| | Labour relations | | | | | | X | | |
| | Health and safety of employees | | | | | | X | | |
| | Hazard risks (e.g., natural disasters, terrorism, accidents) can lead to property damage, business interruption/supply chain disruption | X | X | X | X | X | X | | X |
| | Realisation of projected benefits from initiatives (e.g., cost cutting, efficiency improvements) | | | X | | X | | | X |

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|------------------------|----------------------|---------|--------|---------------|-----|---------|-----------|-----------|-----|-------------------|----------|
| | X | X | | X | | X | | | X | | X |
| | X | X | | X | | X | | | X | | X |
| | X | | | X | | X | | | | | X |
| X | X | X | X | X | | X | | X | X | X | X |
| X | X | X | X | X | | X | | X | X | | X |
| | | X | X | | | X | | | | X | |
| | X | X | X | X | | X | | | X | | X |
| | | | | | X | X | | | | | X |
| | X | X | | X | | X | | X | | X | X |
| | X | X | | X | | X | | X | | X | X |
| | | X | | | | | | X | | X | |
| | X | | | | | | | X | | | |
| | X | X | | X | | X | | | | X | X |
| | X | X | | X | X | X | | X | X | X | X |
| | | | | | | | | | X | X | X |
| | | | | | | | | | | | |
| | X | X | X | X | X | X | | | X | X | |
| | X | X | X | X | X | X | | | X | X | X |
| | X | X | X | X | | X | | | X | X | X |
| | | | | X | | | | | | | |
| | X | | | | X | | | | | | |
| | | | | X | | | | | | | |
| | X | X | X | X | X | X | | X | X | X | X |
| | | | X | | X | X | | X | X | X | X |
| | X | | | X | X | | | | | | |
| | X | | X | X | | | | | | | |
| | | X | | | | | | | | | |
| | X | X | X | X | X | | | | X | X | X |
| | X | | | | | | | X | | | X |

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