



Consumer products IFRS financial statements survey

November 2010



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Executive summary

In this third edition of our consumer products IFRS financial statements survey, we have surveyed the leading consumer products (CP) entities in Europe, applying IFRS. We have updated our observations from 2008 and addressed additional issues that have arisen in 2009.

While the application of IFRS is now generally well understood and embedded within entities' operations, there are significant areas of judgment that remain. Furthermore, as IFRS continues to evolve, its application will be an ongoing challenge for management.

Focus of the survey

The objective of this survey is to summarise CP industry financial performance and to highlight the business risks and KPIs identified by survey respondents. The survey also analyses industry practice with respect to the key IFRS accounting challenges for CP entities.

Our survey looked at recently published financial statements of 20 leading CP entities in Europe.

The survey is focused on CP-specific IFRS challenges rather than general IFRS topics. The CP-specific issues we considered relate to:

- ▶ Intangible assets, including goodwill
- ▶ Hedge accounting

The survey also addresses amendments to IFRS effective in 2009 and their implications for CP entities. Therefore, the following issues are considered in this survey:

- ▶ Disclosures of financial instruments
- ▶ Segment reporting

Under "Other issues" we also discuss advertising costs and agency relationships as well as the proposed new approaches to revenue recognition, lease accounting and defined benefit plans.

Performance review

Given the difficult economic circumstances in recent years, the surveyed CP entities surveyed performed relatively strongly in 2009, although within comparable product categories, performance figures vary widely.

On average, 2009 EBITDA margins in our survey entities were slightly higher than in 2008. Return on equity levels in 2009 decreased compared to 2008, partly because of the impact of the financial crisis, but also reflecting the success of cost saving programs.

Half of the entities surveyed reduced their long-term debt ratios. However, the average long-term debt-to-equity ratio rose, indicating many CP entities faced difficulties financing their costs as revenue and net income decreased.

In terms of operational performance, many entities realised a slightly lower return on assets compared to 2008. Even within comparable product categories, however, performance figures vary widely. While some CP entities enjoy very high asset utilisation, others have a higher EBIT margin (due to a better pricing strategy or lower cost base) but a low level of asset turnover.

Risks and key performance indicators (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 in the annual report, the different ways CP 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 over half of total assets. Therefore, there is a significant risk of impairment, should consumer tastes (and spending patterns) change.

Compared with 2008, however, impairment losses did not increase notably and remain at low levels. The impact of the financial crisis does not appear to be significant with regard to goodwill and brand valuation.

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 the assumptions used in the models.



Hedge accounting

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.

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.

Financial instruments – disclosures

IFRS 7 *Financial Instruments: Disclosures* introduced a number of new disclosure requirements for financial instruments and financial risks. Among others, entities are required to identify financial risk factors and to present a quantified analysis of their exposure.

All CP entities in our survey identified risks such as foreign exchange risk, interest rate risk, liquidity risk and credit risk, and some CP entities also analyse their exposure to equity risks and commodity pricing risks.

The quantitative data is generally presented using a sensitivity analysis, although a minority of CP entities use a value at risk analysis.

Segment reporting

IFRS 8 *Operating Segments* replaced IAS 14 *Segment Reporting* and was effective for all entities for periods beginning on or after 1 January 2009. The majority of entities have adopted IFRS 8 without any changes to the presentation of segment information compared with IAS 14.

IFRS 8 follows a management approach. Linking financial segment reporting with an entity's internal management reporting leads to a range of different approaches being used. The segment information presented may be different from the information presented in accordance with IFRS, and therefore, reconciliations of the segment information to the information contained in the primary financial statements are required.

Other issues

Advertising costs

Spending on advertising, promotions and sponsorship remains very significant for CP entities. The IASB amended IAS 38 *Intangible Assets* to clarify that all expenditure on advertising and promotions must be expensed when the services are received.

The implementation of the amendment has led to earlier recognition of advertising costs as they are now expensed as incurred.

Defined benefit plans

Proposed amendments to IAS 19 *Employee Benefits* would remove the "corridor mechanism," which allows entities to defer certain actuarial gains and losses from the measurement of defined benefit obligations and thus to reduce the volatility in financial reporting.

Seven of the 20 entities surveyed currently use the corridor mechanism to account for pensions. If the corridor is removed, entities will have to recognise all changes in the fair value of defined benefit obligations, which will lead to an increased volatility of net assets.

Revenue recognition

The entities surveyed rarely report on accounting for agency agreements with retailers. Increased control over the distribution process and concepts such as shop-in-shop concessions is likely to increase the identification of agency arrangements.

On the topic of revenue recognition we also analyse the latest proposals by standard setters for recognition of revenue from contracts with customers.

Lease accounting

Rounding off our discussion of other issues, we analyse the proposed changes to accounting for leases, which could particularly affect entities in the luxury and apparel sectors.

Thomas Harms, IFRS Leader, Consumer Products.

Focus of the study



Our survey focused on the following 20 large European publicly listed CP entities applying IFRS. We analysed annual financial statements published up to 31 March 2010.

Entities surveyed

Entity	Location	SEC listing	Financial year-end
adidas	Germany	No	31 December 2009
Anheuser-Busch InBev	Belgium	No	31 December 2009
Beiersdorf/Tchibo ¹	Germany	No	31 December 2009
British American Tobacco	UK	No	31 December 2009
Christian Dior/Louis Vuitton Moët Hennessy (LVMH) ²	France	No	31 December 2009
Compagnie Financière Richemont	Switzerland	No	31 March 2010
Danone	France	No	31 December 2009
Diageo	UK	Yes	30 June 2009
Heineken	Netherlands	No	31 December 2009
Henkel	Germany	No	31 December 2009
Imperial Tobacco Group	UK	Yes	30 September 2009
L'Oréal	France	No	31 December 2009
Nestlé	Switzerland	No	31 December 2009
Pernod Ricard	France	No	30 June 2009
PPR3	France	No	31 December 2009
Reckitt Benckiser Group	UK	No	31 December 2009
SABMiller	UK	No	31 March 2010
Swedish Match	Sweden	No	31 December 2009
The Swatch Group	Switzerland	No	31 December 2009
Unilever	UK/Netherlands	Yes	31 December 2009

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

2. Christian Dior and Louis Vuitton Moët Hennessy have been treated as one entity for the purposes of the performance review and the other analyses within this survey (financial statements of Christian Dior as of 31 December 2009).

3. PPR formerly Pinault-Printemps-Redoute.

4. Cadbury is not included in the current survey, as the entity became part of Kraft Foods on 2 February 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 ¹	% change from prior year	Net income	% change from prior year	Total assets	% change from prior year
adidas	10,381	-4%	245	-62%	8,875	-7%
Anheuser-Busch InBev	26,510	65%	4,238	>100%	78,110	-4%
Beiersdorf/Tchibo	8,906	-3%	412	-32%	11,840	2%
British American Tobacco	15,959	4%	3,320	-1%	30,007	6%
Christian Dior/LVMH	17,745	-1%	1,902	-14%	36,053	1%
Compagnie Financière Richemont	5,176	-4%	600	-44%	7,729	4%
Danone	14,982	-2%	1,521	2%	26,873	0%
Diageo	10,931	-1%	2,025	-7%	21,281	5%
Heineken	14,701	3%	1,142	>100%	20,180	-2%
Henkel	13,573	-4%	628	-49%	15,818	-2%
Imperial Tobacco Group	16,899	27%	776	34%	34,837	-5%
L'Oréal	17,473	0%	1,795	-8%	23,292	1%
Nestlé	71,270	3%	7,810	-35%	74,641	5%
Pernod Ricard	7,203	9%	966	11%	24,875	35%
PPR	16,525	-4%	1,044	0%	24,464	-9%
Reckitt Benckiser Group	8,709	5%	1,593	13%	9,765	4%
SABMiller	12,794	-3%	1,478	-3%	27,753	16%
Swedish Match	1,338	-2%	296	25%	1,586	-5%
The Swatch Group	3,400	-5%	505	-4%	5,179	7%
Unilever	39,823	-2%	3,659	-31%	37,016	2%

1. Revenue net of duty and similar items.

Entity	Equity	% change from prior year	Goodwill	% change from prior year	Brands	% change from prior year
adidas	3,776	11%	1,478	-1%	1,342	-3%
Anheuser-Busch InBev	23,026	31%	36,183	2%	15,032	-8%
Beiersdorf/Tchibo	7,279	4%	1,919	0%	3,528	0%
British American Tobacco	8,921	20%	12,776	9%	786	9%
Christian Dior/LVMH	16,121	6%	4,901	-3%	9,152	3%
Compagnie Financière Richemont	5,660	26%	164	6%	0	n/a
Danone	13,309	53%	12,927	5%	3,903	1%
Diageo	4,629	-12%	427	-3%	5,434	4%
Heineken	5,647	19%	5,433	2%	1,274	1%
Henkel	6,544	0%	6,137	0%	1,981	-9%
Imperial Tobacco Group	7,196	-10%	14,922	0%	7,824	-4%
L'Oréal	13,598	18%	5,466	-1%	1,176	0%
Nestlé	36,091	-2%	18,507	-10%	2,965	4%
Pernod Ricard	7,615	15%	4,888	53%	11,228	59%
PPR	11,053	3%	5,565	-10%	9,766	0%
Reckitt Benckiser Group	4,526	34%	1,865	6%	4,997	3%
SABMiller	15,243	25%	8,572	30%	3,039	12%
Swedish Match	88	-30%	253	-12%	109	-19%
The Swatch Group	4,019	10%	138	1%	0	n/a
Unilever	12,536	21%	12,464	7%	4,05	4%

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
Beverages	Anheuser-Busch InBev, Pernod Ricard, Heineken, Diageo, SABMiller
Food	Danone, Nestlé, Unilever
Household and personal care	L'Oréal, Beiersdorf/Tchibo, Henkel, Reckitt Benckiser Group
Tobacco	Swedish Match, British American Tobacco, Imperial Tobacco Group
Luxury and apparel	Christian Dior/LVMH, PPR, adidas, Compagnie Financière Richemont, The Swatch Group



Recession impacted performance of consumer products entities

The year 2009 was the worst for global economic performance since the Great Depression of the 1930s. Hardest hit were the financial sector and manufacturing industries such as automotive and related sectors. The CP industry did not suffer as much as feared, although as predicted in our last survey, CP businesses did not escape unscathed.

In 2009, more than half of the entities in our survey – namely 13 out of 20 – experienced a decrease in turnover compared to the previous year. Hardest hit were luxury and apparel entities. Every entity in this subsector registered a sales drop that was on average higher than in any other subsector. Beverages showed the best performance, although the reported sales increase by InBev was significantly impacted by the takeover of Anheuser Busch.

In terms of net income, the picture was similar. Twelve entities – mostly those that experienced a drop in turnover – also suffered a decrease in net income. This was true particularly of the HPC, food and luxury and apparel subsectors, where net income decreased more than 19% on average. Tobacco, by contrast, realised a double-digit increase, largely because smokers consider tobacco an essential rather than discretionary purchase.

Although approximately half of the entities surveyed suffered a decline in net income and revenue, profitability held up reasonably well due to the introduction of efficiency and cost saving programmes before the recession struck. These measures are likely to bear fruit in entities' 2010 results.

External challenges are shifting

While in 2008, CP entities had to fight a battle against inflation caused by increasing costs for agricultural commodities, property, energy and wages, in 2009 they faced cuts in consumer spending and a shift in consumer demand. Although many signs indicate that recovery may be under way faster and earlier than expected, global pre-crisis consumer spending behaviour is not expected to return before 2011 at the earliest, if at all, depending on subsector and geographic market.

Before the financial crisis, consumer spending in the US, UK, Spain and Ireland was running at high levels, partly financed by borrowings secured against the value of consumers' homes. Once the real estate bubble burst and its impact was felt globally,

indebted households (primarily in the areas most affected) tightened their budgets, paid off debts, increased savings and cut back on non-essentials (e.g., luxury products, apparel, home furnishings, eating and drinking out).

In markets less strongly affected by the crisis, the consumer response was more muted, although across many countries, consumers reset their perceptions of value – becoming smarter, more demanding and increasingly value-focused. They compared products, traded down and switched to private label, which increased pressure on brand manufacturers further. At the same time, the drive for healthier, safe and convenient food, sourced in a more sustainable, fair and ethical manner, continued to gather force.

In developing markets, by contrast, consumers' main concern remained that products should be affordable, of good quality and tailored to their cultural needs and preferences.

Many entities have emerged stronger

Responding to the crisis, many CP entities took the opportunity to restructure and introduce cost-cutting measures. Investments were frozen, marketing budgets were cut, mergers, acquisitions and IPOs were postponed.

Many businesses also focused heavily on promotions and discounting, while continuing to emphasise innovation to maintain market share and drive growth. In many cases, leaner and fitter businesses emerged that were more customer focused and better at delivering on their corporate social responsibility (CSR) commitments. In turn, this meant that decreases in turnover were lower compared with other industries. Overall, because of this combination of measures, 2009 ended on a less negative note for CP entities than many economists expected.

A number of entities have now started to rebound (some earlier and more strongly than even they had forecasted), with stronger balance sheets and an improved capital position. Businesses such as these are continuing to revise their portfolios by concentrating on core competencies, making strategic investments and selling non-core businesses.



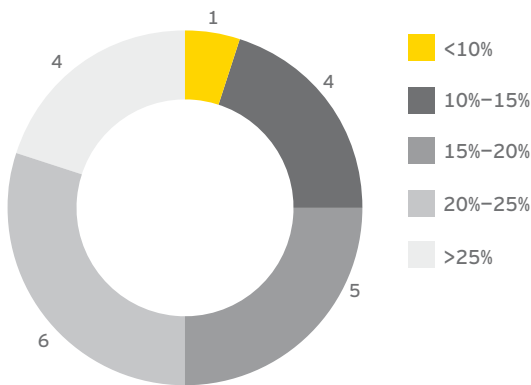
Financial performance¹

As in 2008, the financial performance of CP entities in 2009 differed widely.

EBITDA margins holding up

The following graphic illustrates five-year average EBITDA margin² for our sample of 20 entities, which measures operating profitability.

Five-year average EBITDA margin



Despite the difficult economic conditions, 10 of the entities surveyed realised EBITDA margins of more than 20% over the past five years (one less than last year). Only one entity earned less than 10% over the same period.

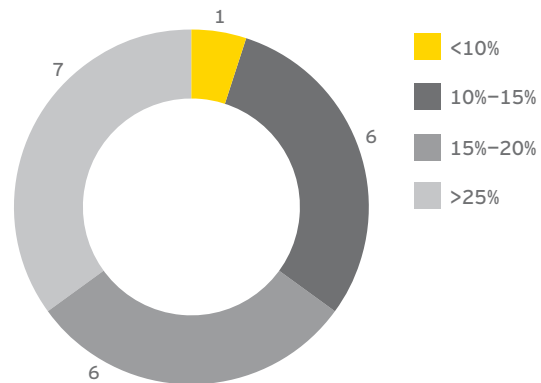
Comparing the 2009 figures to the average of the four prior years, eight entities realised EBITDA margins exceeding their 2005 to 2008 averages. On average, EBITDA margins in 2009 were marginally higher (20.2%) than in 2008 (20.0%) and in the four prior years (20.1%). This reflects the success of the cost cutting measures undertaken by many CP entities. The only subsector realising lower EBITDA margins in 2009 compared to 2008 was luxury and apparel.

Return on equity (RoE) declining

At first sight, the picture shown by return on equity³ (RoE) appears different from the development of EBITDA margins. The RoE realised on average in 2009 (30.6%) was not only below the average of 2008 (31.2%) but also below the average of the four prior years (33.1%). Six surveyed entities, four of them beverage businesses, managed to generate profits from every unit of shareholders' equity more effectively than in the four prior years.

One explanation for the lower RoE ratios is crisis-related: lower consumer spending led net incomes to dwindle. But cost cutting measures also played a part. In 2009, 16 of the 20 entities surveyed increased their equity, compared to 2008. The equity increase was mainly achieved through retained earnings/profits.

Five-year average RoE



None of the entities surveyed achieved a five-year average RoE in the range of 20%-25%, but as in the previous year, seven entities earned a RoE of more than 25% in 2009. The range of realised five-year average RoEs was very wide in 2009 – running from 6.9% to about 208%. The latter extremely high ratio can be attributed to the very low equity levels of the entity concerned.

¹ 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., July, 2010. The exceptions are maxingvest, where we used the OneSource figures provided for Beiersdorf, maxingvest's major subsidiary. Data relating to Henkel was taken from Bloomberg.

² EBITDA divided by total revenues.

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



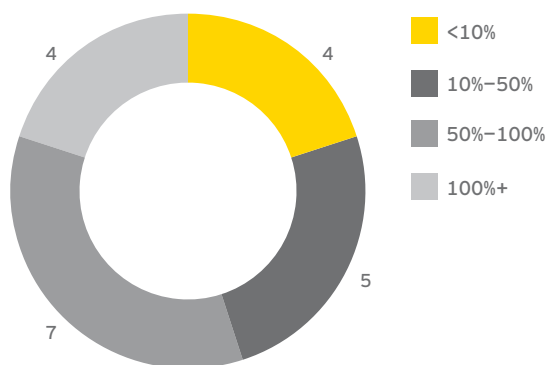
Bond issuance drives debt-to-equity ratios

The impact of the financial crisis can also be seen in changes to the debt-to-equity ratio,⁴ which indicates the proportions of equity and debt an entity is using to finance its assets.

Compared to 2008, nine CP entities reduced their debt-to-equity ratios, most of them both by raising equity and reducing debt levels. However, the remaining entities increased their long-term debt or held it at the same level – mainly by issuing bonds to circumvent limited access to credit. As this debt increase outweighed the reduction in the other half of the survey, the average long-term debt ratio rose from 107.7% in 2008 to 114.1% in 2009.

In 2009, seven CP entities were facing a debt-to-equity ratio of more than 100%, while the remaining 13 CP entities had less long-term debt than equity. In our 20-entity sample, the debt-to-equity ratio of 19 entities ranged from 0% to 239%, but one entity featured a particularly high ratio of 918% because its equity amounted to only €88m.

Five-year average long-term debt to equity



On average, over the past five financial years, 11 CP entities had long-term debt-to-equity ratios of more than 50%. This means that many CP entities have been using debt instruments to finance their growth and continued to do so in 2009.

We expect the effects of the financial crisis to diminish in CP entity financial statements for fiscal year 2010. With the recovery already under way in the first half of 2010, the lower levels of turnover and net income witnessed in 2009 are likely to be exceeded this year. This should improve corporate financial ratios, i.e., increasing EBITDA margins and return on equity ratios. However, as access to credit becomes easier while interest rates remain low, higher long-term debt to equity ratios can also be expected.

4 Long-term debt divided by total equity.

Operational performance

Operational performance figures are independent from the financing of entities and therefore reveal information about the actual operational success of the business. As the operations of the CP entities surveyed are different in nature, we compared only those CP entities that operate in the same product category as defined in the “Focus of the study” chapter.

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

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

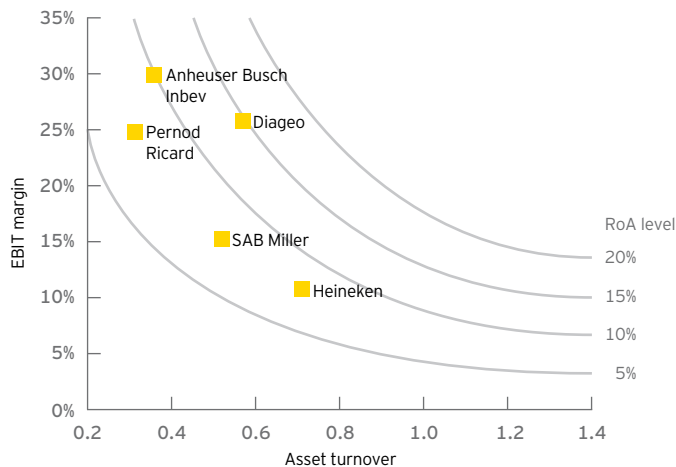
The return on assets (RoA) ratio⁷ shows what earnings were generated from invested capital and is a measure of how profitable an entity is relative to its total assets.

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%.

Beverages: Diageo heads the pack



5 EBIT divided by total revenues.

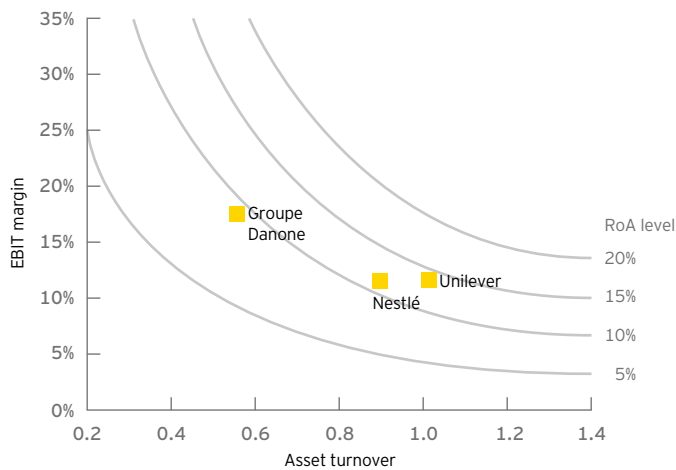
6 Total revenues divided by assets.

7 EBIT divided by assets.

Pernod Ricard, SABMiller, Anheuser-Busch Inbev and **Heineken** all realised a similar level of RoA of between 5% and 10% in 2009, a similar performance to 2008. **Anheuser-Busch Inbev, Diageo** and **Pernod Ricard** achieved high EBIT margins in the beverage product category. However, both **Pernod Ricard** and **Anheuser-Busch Inbev** had low asset turnover, because of their relatively high level of assets. **Diageo** turned out to be the strongest entity due to its high EBIT margin and a RoA of 14.4%.

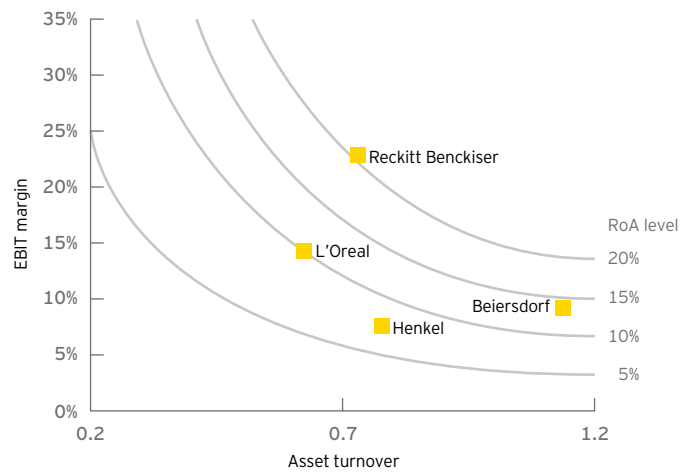
Heineken benefited from a high asset utilisation, generating high revenue from a comparatively low level of assets. This compensated for its lower EBIT margin.

Food: return on assets under pressure



In 2009, both **Nestlé** and **Unilever** realised a much lower return on their assets (12% and 14%, respectively), compared to 2008 (about 20%). Nevertheless, they had higher RoAs than **Danone**. While **Nestlé** and **Unilever** took advantage of a very high asset turnover of around one (a level that was only exceeded by two other entities in the survey), **Danone's** RoA was backed by a high EBIT margin.

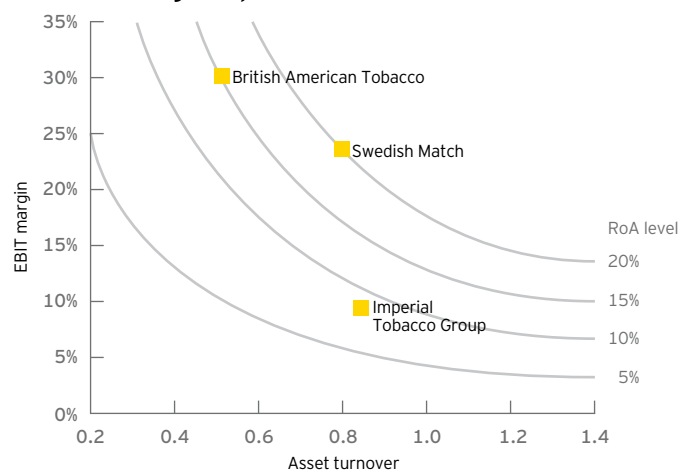
Household and personal care: Henkel hard hit



Performance in the HPC category was more varied, primarily due to the wide number of different product ranges. Repeating its 2008 performance, **Reckitt Benckiser** was the strongest entity in our survey, realising the highest RoA in 2009 (21.2%) due to an outperforming EBIT margin and a high asset turnover. In contrast, **L'Oréal** and **Beiersdorf** achieved only about half of this level. While **L'Oréal** benefited from a higher EBIT margin, **Beiersdorf** generated the highest asset turnover of all entities surveyed.

Henkel realised the lowest RoA due to a relatively low EBIT margin. **Henkel** has been hit hard by the financial crisis, as its adhesives business, which is highly dependent on the automotive industry, accounts for 46% of turnover.

Tobacco: margins up at Swedish Match

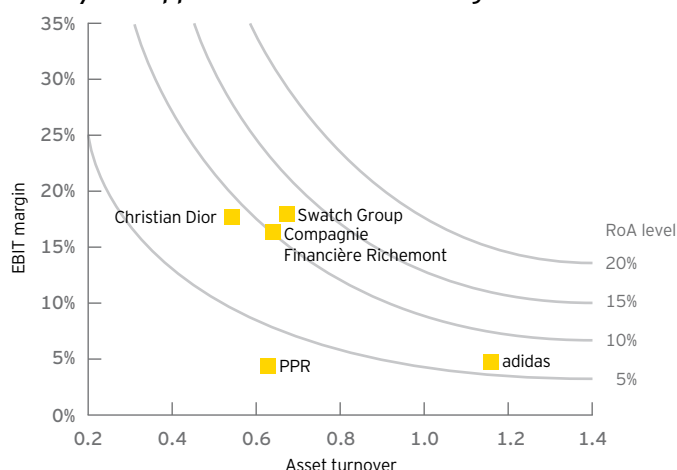




Compared with 2008, **Swedish Match** improved its already strong RoA level to 19.7%, despite the fact that, in terms of turnover, the entity is the smallest in the tobacco category. **British American Tobacco** achieved the highest EBIT margin compared to its two competitors, but with a lower asset turnover. **Imperial Tobacco's** asset turnover was only slightly higher than that of **Swedish Match**, but combined with an EBIT margin of under 10% it realised the lowest RoA.

Ongoing regulatory restrictions in the tobacco industry suggest that in future this industry may face further pressure. This is likely to have adverse effects on entity financial ratios.

Luxury and apparel: resilience at the high end



Performance was also very varied in the luxury and apparel segments. Although consumer spending cutbacks have hit the luxury goods industry, **Dior**, **Richemont** and the **Swatch Group** realised a return on assets of around 10%, which was driven by high EBIT margins. **PPR** and **adidas** achieved the lowest returns on assets, even though **adidas** had one of the highest asset turnover levels among the entities surveyed. This result is a function of pricing strategy: CP 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 lower return on assets.

Key findings

Given the difficult economic circumstances, the CP entities surveyed performed relatively strongly in 2009. On average, 2009 EBITDA margins in our survey entities were slightly higher than in 2008. Almost half of the entities were able to realise a five-year average margin of more than 25%. Return on equity levels in 2009 decreased compared to 2008, partly because of the impact of the financial crisis, but also reflecting the success of cost saving programs. Half of the entities surveyed reduced their long-term debt ratios. However, the average long-term debt-to-equity ratio rose, indicating many entities faced difficulties financing their costs as turnover and net income decreased.



Risks and KPIs: the need for better communication

Financial stakeholders often find it difficult to form a clear picture from financial performance information.⁸ Instead, they rely on management forecasts and performance analysis, including data on key performance indicators (KPIs). Participants in this survey have bemoaned the quality of current risk disclosure and pointed out the need for effective communication and disclosure on enterprise risks.

The discussion about business risks and effective risk management at global firms is a live issue. Reflecting this, Ernst & Young published on 30 June 2010 the Business Risk Report 2010⁹ global survey by more than 70 business executives and academic analysts representing 14 industry sectors, the third edition of this annual publication. In our survey, we reviewed the reporting of business risks and KPIs in the annual reports of all 20 entities, in the context of the broader CP sector behaviour identified in the Business Risk Report. Our key findings are presented below.

The table in the appendix shows the key risks identified by the entities in our survey.

Risks

The top ten business risks faced by CP entities differ from those identified and ranked in the Business Risk Report. Regulation and compliance is the number one business risk across all industries, according to the Business Risk Report. CP entities attach particular importance to the following risks:

- ▶ Consumer dynamics and demographic shifts
- ▶ Speed and success of innovation
- ▶ Pricing pressures and pricing strategy
- ▶ Brand and marketing effectiveness
- ▶ Supply chain agility and resilience

The reporting of business risks differs for each entity, depending on managements' views of what is most important. It is difficult, therefore, to make comparisons across CP entities. In this section, we have highlighted the most common risks identified by the CP entities in our survey, which overlap with the significant risks outlined in the Business Risk Report.

While some entities state a wide range of risks, as illustrated in the appendix, others focus on risks that are expected to have the most significant impact on their financial performance. For example, the annual reports of **Richemont** and the **Swatch Group** do not have a disclosure paragraph concerning significant risks, uncertainties and control policies and only present an explanation in terms of financial risk management.

The number of risks disclosed by the surveyed CP entities ranged from six to 23, with an average of 15. Within the surveyed CP group, there is also a wide range of depth of coverage of the identified risks. For example, **Unilever's** report includes a table describing both the risks identified and the action taken by the entity to manage this risk. In a similar fashion, **Imperial Tobacco Group** 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.

adidas has created a matrix, which presents the probability of occurrence and the potential financial impact of external, industry, strategic, operational and financial risks with an assessment ranging from low to high.

It is worth noting, however, that there is a balance to be struck, since increasing the number of risks disclosed could attract criticism that the group is not focused on those risks that are truly "principal" to its business.

⁸ www.ey.com/publication *The top ten risks for business: a sector-wide view of the risks facing businesses across the globe.*

⁹ www.ey.com/publication *The financial communication challenge.*



Market risks: recession/competition top the list

The main “market risks” disclosed by our surveyed CP entities are the recession and competitive pressure.

The recession, leading to weaker consumer demand, is considered a principal risk by 14 of the surveyed CP entities. 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, **Danone** states:

“As a major player in the food and beverage industry, the Group’s sales are dependent on the overall economic climate of its principal geographic markets to varying degrees according to its needs. In periods of economic slowdown, the Group may have to contend with reduced spending by consumers whose purchasing power has declined and changing consumption patterns as a result of economic conditions. These events may have adverse effects on the Group’s business activities and on its results.”

Danone, Annual Report 2009, page 7

The majority of the surveyed CP entities regard the threat posed by competitors as a principal risk. **Diageo** disclosed this key risk as follows:

“Diageo faces substantial competition from several international companies as well as local and regional companies in the countries in which it operates. Diageo competes with drinks companies across a wide range of consumer drinking occasions. Within a number of categories, consolidation or realignment is still possible. Consolidation is also taking place amongst Diageo’s customers in many countries. Increased competition and unanticipated actions by competitors or customers could lead to downward pressure on prices and/or a decline in Diageo’s market share in any of these categories, which would adversely affect Diageo’s results and hinder its growth potential.”

Diageo, Annual Report 2009, page 28

Strategic risks: brand management is key

Within the “strategic risk” category the risk of continued product innovation and failure to ensure relevance and attractiveness of brands was noted by 12 of the 20 surveyed CP entities. The other strategic risks disclosed were: reputation; development and maintenance of talent; and the inability to predict consumers changing behaviour.

SABMiller articulates the challenge of continuous product innovation and successful portfolio management as follows:

“Change in consumer preferences

Context

Consumer tastes and behaviours are constantly evolving and competitor activity is increasing and becoming more sophisticated. Strong brand portfolios together with excellence in marketing and sales execution are required if we are to meet consumer, shopper and customer needs.

Risk

Failure to ensure the attractiveness of our brands; failure to continuously improve our marketing and related sales capability to deliver consumer relevant propositions.

Possible impact

Market positions come under pressure, lower volume growth rates and profitability.

Associated strategic priorities:

- ▶ Developing strong, relevant brand portfolios that win in the local market.
- ▶ Constantly raising the profitability of local businesses, sustainably.
- ▶ Leveraging our skills and global scale.
- ▶ Ongoing focus on building our marketing and sales capabilities through continued roll-out and enhancement of the SABMiller Marketing Way.
- ▶ Ensuring that our brand equities remain strong through relevant innovation and compelling marketing programs.
- ▶ Ongoing evaluation of our brand portfolios in every market to ensure that they target current and future opportunities for profitable growth.”

SABMiller, Annual Report 2009, page 24

Operational risks: securing the supply chain

The principal "operational risks" disclosed relate to supply shortages, increased prices, product quality and safety, supply chain disruption and IT risks and security. In addition, the surveyed CP entities also regard regulatory constraints on products, taxes and duties, regulatory constraints on import and export (mentioned by 14 entities) and the protection of intellectual property as key risks.

adidas describes the principal risk from rising raw material prices, their impact on operating margins and its mitigating strategies as follows:

"Risks from rising input costs

Raw material and labour costs account for approximately 70% of the Group's cost of sales. Prices of materials such as rubber, and those which closely correlate with the oil price, are especially subject to the risk of price changes. As our ordering process and price negotiations usually take place around six months in advance of production, our sourcing function has visibility and reaction time to manage and plan for sharp increases in input costs.

To reduce the financial impact on our product margins from higher sourcing costs, we are implementing further lean manufacturing techniques at our partner factories, eliminating time and cost from the procurement process, reengineering our products and selectively increasing prices where possible."

adidas, Annual Report 2009, page 146

CP entities that manufacture foods focus on the operational risk arising from product quality and safety, ingredients and contamination, but this is also considered to be a principal risk by other entities operating in the household and personal care and luxury and apparel sectors. In addition, **Unilever** has a special focus on the environmental aspects of operational risk:

"Description of risk

Consumer safety and environmental sustainability

- ▶ Maintaining high social and environmental standards
- ▶ Designing and producing products that are safe for consumers
- ▶ Building an environmentally sustainable business

Unilever has developed a strong corporate reputation over many years for its focus on social and environmental issues, including promoting sustainable development and utilisation of renewable resources. The Unilever brand logo, now displayed on all our products and advertising, increases our external exposure. Should we fail to meet high product safety, social, environmental and ethical standards across all our products and in all our operations and activities it could impact our reputation, leading to the rejection of products by consumers, damage to our brands including growth and profitability, and diversion of management time into rebuilding our reputation. We aim to grow our business while reducing our environmental impact. The environmental measures that we regard as most significant are those relating to the amounts of CO2 from energy that we use, the water we consume as part of our production processes and the amount of waste that we generate for disposal. Failure to design products with a lower environmental footprint could damage our reputation and hence long-term cash flow, turnover, profits and/or profit margins.

What we are doing to manage the risk

Our Code of Business Principles and other operational and business policies are designed to ensure that we consistently maintain high social and environmental standards, and we have established processes to track performance in these areas. Our strategy benefits from the insights of the Unilever Sustainable Development Group, comprising five external specialists in corporate responsibility and



sustainability that guide and critique the development of our strategy. Detailed operational policies and procedures ensure that quality and safety are built in to the design, manufacture and distribution of all of our products. Procedures are also in place to respond quickly to consumer safety and quality incidents including provision to initiate product recalls where necessary.”

Unilever, Annual Report 2009, page 33

Since issues around product quality and safety and a possible disruption in the supply chain continue to be of major importance to the majority of customers, nearly all of the CP entities include specific risks regarding product contamination and ingredients. **maxingvest** has disclosed the risk in its annual report as follows:

“Beiersdorf is subject to procurement risk with regard to delivery reliability, the cost of raw materials and upfront expenditures on purchased goods and services. It counteracts these risks by continuously monitoring its markets and ensuring active management of its supplier portfolio, as well as appropriate contract management. Production and logistics activities may be exposed to risks relating to occupational health and safety, the environment and business interruption. Beiersdorf limits these risks through process control checks and location-specific audits. Moreover, selected risks are transferred to insurance companies.”

maxingvest, Annual Report 2009, page 52

British American Tobacco describes the potential risk from supply chain disruption as follows:

“Inability to obtain adequate supplies of leaf

Principal relevance to Group strategy: Potential impact on Growth (organic revenue growth)

Principal potential causes

- ▶ Natural disasters, including major impact of climate change
- ▶ Competition for land use
- ▶ Agricultural products
- ▶ Government initiatives to move farmers away from tobacco
- ▶ Potential impact on Group
- ▶ Increased blend costs through lack of supply
- ▶ Potential deterioration in smoke quality impacting consumer
- ▶ Loss of market share in one or more markets
- ▶ Principal activities in place to address risk
- ▶ Global sourcing and globally integrated management of leaf supply chain
- ▶ On average, two-thirds of tobacco requirements met from within Group
- ▶ Three year planning cycle to identify and manage potential shortages
- ▶ Scenario planning and contingency plans”

British American Tobacco, Annual Report 2009, page 36

CP entities selling tobacco products and alcoholic beverages, in particular, are subject to regulatory restrictions. Hence **Imperial Tobacco Group** has stated that any future tightening in regulations might have an adverse effect on its financial performance:



“Regulation

Overview

The tobacco industry is subject to substantial and increasingly restrictive regulatory practices worldwide. In many of the countries in which we operate, there are regulatory restrictions affecting a wide range of matters including where tobacco products can be smoked and their development, content, manufacture, packaging and labelling, testing, data reporting, sale, distribution, display, marketing and advertising. It is expected that further regulation will be implemented. The Group along with all other tobacco manufacturers is often excluded from engaging with regulators on these regulatory proposals. Any future increases in regulation of the tobacco industry could have an adverse effect on the demand for our products or increase the costs related to compliance and could contribute to an increase in illicit trade.

Mitigation

We employ a number of senior and experienced Corporate Affairs specialists to manage regulatory risk and where possible engage with regulators. We monitor proposals for new measures globally and analyse them to identify their potential impact on the Group and its products.”

Imperial Tobacco Group, Annual Report 2009, page 16

KPIs

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

While some CP entities have explicitly identified their KPIs, others have 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) within the annual reports.

The most frequently mentioned KPIs – by more than 50% of the CP entities surveyed – are revenue growth, operating profit and net profit, free cash flow and earnings per share.

Almost 50% of the entities within the surveyed group have an explicit sustainability KPI. Furthermore, some CP entities publish a separate sustainability report instead of including this information in the annual report or pursuing sustainability issues with only internal reporting.

Best practice suggests that targets should be communicated in relation to each of the KPIs. Not all of the CP entities surveyed, however, follow this policy.

Since 2006, **Diageo** has explicitly recognised free cash flow as a KPI. We observed that the majority of entities surveyed consider it more relevant than ever to have KPIs associated with cash flow and liquidity. **Diageo’s** disclosure in their most recent Annual Report was as follows:

“Free cash flow is a non-GAAP measure that comprises the net cash flow from operating activities as well as the net purchase and disposal of investments and property, plant and equipment that form part of net cash flow from investing activities. The group’s management believes the measure assists users of the financial statements in understanding the group’s cash generating performance as it comprises items which arise from the running of the ongoing business. The remaining components of net cash flow from investing activities that do not form part of free cash flow, as defined by the group’s management, are in respect of the purchase and disposal of subsidiaries, associates and businesses. The group’s management regards the purchase and disposal of property, plant and equipment as ultimately non-discretionary since ongoing investment in plant and machinery is required to support the day-to-day operations, whereas acquisitions and disposals of businesses are discretionary. However, free cash flow does not necessarily reflect all amounts which the group either has a constructive or legal obligation to incur. Where appropriate, separate discussion is given for the impacts of acquisitions and disposals of businesses, equity dividends paid and the purchase of own shares, each of which arises from decisions that are independent from the running of the ongoing underlying business.”

Diageo, Annual Report 2009, page 34



Some CP entities, such as **Henkel**, **Heineken** and **British American Tobacco**, focus on market share by region 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 in local markets. While **Heineken** has calculated and explained the market share for various countries in which it operates (Austria, Poland, Greece, Czech Republic), **Henkel** has investigated and presented market share from a business segment perspective (toiletry/cosmetics, adhesive technologies). **British American Tobacco** presents a graphic showing its share of key markets and in the accompanying text analyses the market share of its various tobacco brands (Pall Mall, Lucky Strike, Dunhill) in different regional areas.

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 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 related to achieving the stated priorities are identified and appropriately mitigated.

The majority of CP entities regard the following risks as the most significant:

- ▶ Recession
- ▶ Competition
- ▶ Changes in consumer preferences
- ▶ Continued product innovation and failure to ensure the relevance and attractiveness of brand
- ▶ Supply shortages and increased prices
- ▶ Successful renewal of supply/distribution agreements
- ▶ Regulatory constraints on products, taxes and duties
- ▶ Financial risks, in particular exchange rate, interest rate, liquidity and commodity price risk

Some CP entities have prioritised these risks, while others have presented a long list without a clear focus or ranking.

Key performance indicators used by the majority of CP entities are sales, operating profit, net profit, operating and/or free cash flow and earnings per share. KPIs related to sustainability have gained importance and are mentioned by almost half of the surveyed entities.

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

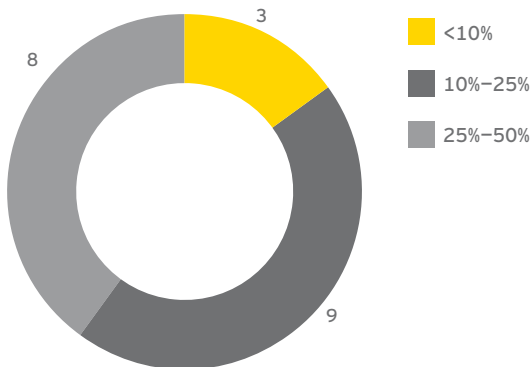
Brands and goodwill represent a significant source of economic value for CP entities – in some instances, brands and goodwill together amount to over half of total assets. Their valuation and especially the decision about possible impairments to these assets are major performance drivers for CP entities.

Accounting for intangible assets is subject to significant judgment and is 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-only approach required by IAS 36 *Impairment of Assets* requires judgmental decisions, which may lead to a range of outcomes.

Goodwill and brands – a major source of value

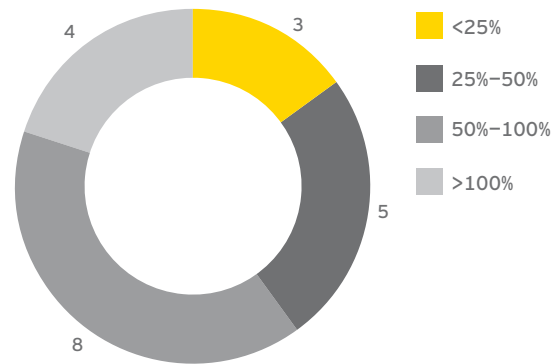
The following graphics illustrate the 20 companies' proportion of goodwill and brands compared with total assets and shareholders' equity.

Goodwill as percentage of total assets



Eight CP entities in our survey (10 in 2008) recognised goodwill that accounted for between 25% and 50% of total assets.

Goodwill as a percentage of shareholders' equity



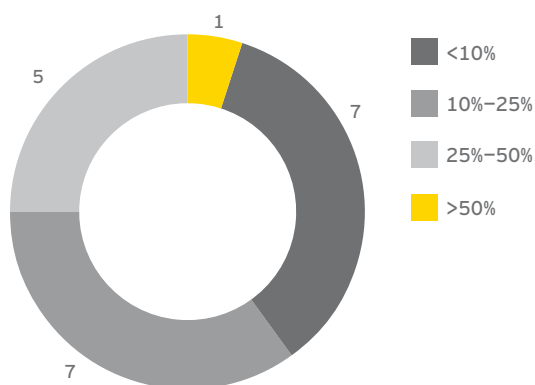
Twelve CP entities (14 in 2008) recognised goodwill amounting to more than half of shareholders' equity, and in four cases (seven in 2008) goodwill exceeded shareholders' equity. The decrease compared with 2008 is due to an increase in shareholders' equity and no significant change in goodwill.

Transaction activity in the CP sector was low in 2009. For example, in the last quarter of 2009 announced deal volume was the lowest for three years, with only household and personal care bucking this trend. Ernst & Young believes that the fourth quarter of 2009 marked the bottom of the market in terms of transaction activity, and deal volumes in the first half of 2010 suggest this optimism is well founded. Readers are referred to the Q4 2009 and subsequent editions of CP Deals Quarterly.¹⁰

¹⁰ www.ey.com/publication Consumer Products Deals Quarterly

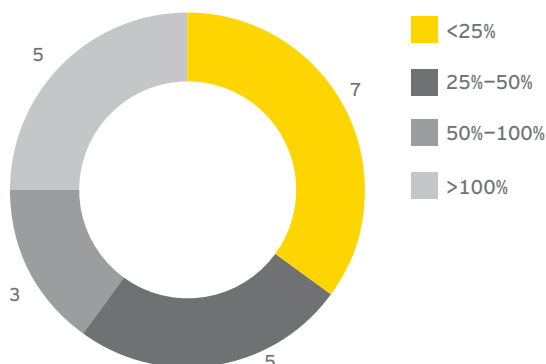


Brands as percentage of total assets



About one third of the entities in our survey recognised brands as representing more than 25 % of total assets in 2009, a similar proportion to the previous year.

Brands as percentage of shareholders' equity



For eight CP entities (nine in 2008), brands represented more than half of shareholders' equity, while for five entities, brands exceeded shareholders' equity.

Goodwill and brands resilient in the face of recession

Goodwill and intangible assets with an indefinite useful life are not amortised, but tested for impairment on an annual basis. The judgments and estimates used for impairment testing purposes can have a large 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 2009, 10 CP entities (nine in 2008) recognised an impairment loss, although the value of the losses was low. The impairment amounted to around 2% of the goodwill recognised at year-end, although **PPR** accounted for the majority of impairments with over 11% of recognised goodwill.

Eight entities surveyed recognised an impairment of brands. All impairments recognised are below 1% of brand value recognised at year-end, 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.

For example, **adidas** acknowledges that:

"Future changes in expected cash flows and discount rates may lead to impairments of the accounted goodwill in the future."

(adidas, Annual Report, page 12)

British American Tobacco, however, has performed a sensitivity test, which provides greater insight into the likelihood of future impairment:

"If discounted cash flows per cash-generating unit should fall by 10 per cent, or the discount rate was increased at an after tax rate by one per cent, there would be no impairment."

(British American Tobacco, Annual Report page 134).

The majority of 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.

Unilever plc uses the following criteria to determine whether brands and trademarks have an indefinite or finite life:

"Finite-lived intangible assets mainly comprise patented and non-patented technology, know-how and software. These assets are capitalised and amortised on a straight-line basis in the income statement over the period of their



expected useful lives, or the period of legal rights, if shorter, none of which exceeds ten years.

Periods in excess of five years are used only where the Directors are satisfied that the life of these assets will clearly exceed that period.

Indefinite-lived intangible assets principally comprise those trademarks for which there is no foreseeable limit to the period over which they are expected to generate net cash inflows. These are considered to have an indefinite life, given the strength and durability of our brands and the level of marketing support."

Unilever plc, Annual Report 2009, pages 83, 93

For brands and trademarks having a finite useful life, the CP entities in the survey used a range from five to 50 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 (CGUs) 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 an operating segment determined in accordance with the applicable standard for segment reporting, i.e., IFRS 8 (or IAS 14 for entities with balance sheet date 30 June 2009).

In our survey, the majority of CP entities identified CGUs 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 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.

"For the purpose of impairment testing, goodwill acquired in a business combination, is allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination. Each unit or group of units to which the goodwill is allocated represents the lowest level

within the entity at which the goodwill is monitored for internal management purposes."

Heineken NV, Annual Report 2009, page 89

"Goodwill is allocated to cash-generating units for the purpose of impairment testing. An allocation is made to the cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose and which are identified according to operating segments."

Compagnie Financière Richemont SA, Consolidated Financial Statements, page 9

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 CP 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 avoids 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 management judgment.

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



The CP entities in our survey based their cash flow projections on detailed forecast periods ranging from three to 10 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 the assumptions used. 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 the cloth to suit your needs

Generally speaking, however, growth rates applied by the majority of surveyed entities are between 0% and 2%, with a maximum of 4%. There are only three entities which have assumed higher long-term sustainable growth rates: **Unilever** uses 9% to 10% for the regional Savoury and Dressings CGU Asia, Africa and Central and Eastern Europe (Unilever, Annual Report page 94); **Diageo** assumes 12.1% and 31.3% for brands and other intangible assets that generate cash flows in Russia/Eastern Europe and International-Venezuela, respectively (Diageo, Annual Report page 125); and **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 95).

The following statements 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 and Dressings CGUs:

- ▶ A longer-term sustainable growth rate of 2% to 3% for Western Europe, 5% for the Americas and 9% to 10% for AAC.
- ▶ Average near-term nominal growth rates for the major product groups within the CGUs of 2% Western Europe, 4.5% The Americas, 9% for AAC.
- ▶ Average operating margins for the major product groups within the CGUs ranging from 16% to 20% Western Europe, 19% to 20% The Americas and 10% to 12% AAC.

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 as a guide."

Unilever, Annual Report 2009, page 94

PPR uses different assumptions depending on the CGU – for example for the Gucci CGU:

"In the case of the Gucci CGU, the recoverable amount of the CGU was determined on the basis of its value in use. Value in use is determined with respect to projected estimated future cash flows, taking into account the time value and specific risks associated with the CGU. Estimated future cash flow projections were prepared during the second half of the year on the basis of budgets and medium-term plans with a four-year timescale. To calculate value in use, a terminal value equal to the perpetual capitalisation of a normative annual cash flow is added to the estimated future cash flows.

The growth rate used to extrapolate projected cash flows to perpetuity is 3.5%.

The pre-tax discount rate applied to projected cash flows is 9.3%."

PPR, Annual Report 2009, page 136.

The assumptions used by **Nestlé** differ depending on the business unit in question. **Nestlé** has presented the outcome and assumptions of the goodwill impairment reviews of the three significant items, which represent more than 50% of the net goodwill book value at year-end. For example, in its Pet Care business **Nestlé** assumes that annual sales growth over the first 10-year period will range from 3% to 4.5% and that EBIT margin evolution ranges from zero to 20 basis points (bp) in the "Zone

Americas" and 20 to 50 bp in the "Zone Europe." In contrast, the main assumptions in its infant nutrition business unit were for annual sales growth of between 1.9% and 5.5% and a steadily improving EBIT margin over the forecast period, ranging from zero to 60 bp. In its Ice Cream USA business, **Nestlé** assumes EBIT margins will steadily improve over the forecast period, with an evolution ranging from 80 to 210 bp per year. (**Nestlé**, Annual Report 2009, pages 77/78).

Heineken has identified five different CGUs, which it evaluates with individual volume growth rates, expected annual long-term inflation, and individual pre-tax discount rates:

"The key assumptions used for the value in use calculations are as follows:

Cash flows were projected based on actual operating results and the three-year business plan. Cash flows for a further seven-year period were extrapolated using expected annual per country volume growth rates, which are based on external sources. Management believes that this forecasted period is justified due to the long-term nature of the beer business and past experiences.

- ▶ The beer price growth per year after the first three-year period is assumed to be at specific per country expected annual long-term inflation, based on external sources.
- ▶ Cash flows after the first ten-year period were extrapolated using expected annual long-term inflation, based on external sources, in order to calculate the terminal recoverable amount.
- ▶ A per cash-generating unit specific pre-tax Weighted Average Cost of Capital (WACC) was applied in determining the recoverable amount of the units."

Heineken, Annual Report 2009, page 110

Heineken has discounted the expected cash flows by a pre-tax weighted average cost of capital, ranging from 10.17% (Western Europe) to 20.04% (Africa and Middle East). It has extrapolated cash flows using an annual long-term inflation from 1.7% (Western Europe) to 7.87% (The Americas) and 7.97% (Africa and Middle East). Assumed volume growth rates range from minus 0.14% (Western Europe) to 3.96% (Africa and Middle East) (**Heineken**, Annual Report, page 111).

maxingvest (Beiersdorf/Tchibo) uses a different approach to test the Beiersdorf trademarks for impairment:

"As in the previous year, the relief from royalty method was used in testing these indefinite-lived Beiersdorf trademarks

for impairment and reversal of impairment losses. As at 31 December 2009, the following significant valuation parameters were used to calculate the net realisable value based on the revenues per brand derived from the business plans:

As in the previous years, the cost savings for the various brands were estimated to be licence fees of 3.5% to 6.0% of revenues, based on typical market licence fees for comparable assets. The discount rate was determined using the WACC method as the weighted average of the cost of equity and cost of debt. The pre-tax rate used to discount the cash flows was 9.8% (previous year: 10.5%). As in previous year, the growth rate outside the planning horizon was between 0% and 2%."

maxingvest, Annual Report 2009, page 93

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 6.9 % to above 25 % depending mainly on geographical area or product group.

Reckitt Benckiser, for example, states:

"A pre-tax discount rate of 10% (2008: 12%) has been used in discounting the projected cash flows. A higher rate is used where appropriate to reflect specific risks associated with the relevant product group range of 10%-18% (2008: 11%-17%)."

Reckitt Benckiser, Annual Report 2009, page 46

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 **Swedish Match** is representative of the majority of entities included in the survey:

"When performing sensitivity analyses by increasing the discount rate by two percentage points, the values in use



were larger than the carrying values of all cash generating units. However, for the Continental Europe cigar operations, the lighters operations and the matches operations the values in use were close to the carrying values.”

Swedish Match, Annual Report 2009, page 72.

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

As of December 31, 2009, 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 have a negative impact of €1.4 billion.
- ▶ A 0.5% decrease in the long-term growth rate would have a negative impact of €900 million for each group of CGUs, the value in use would remain greater than net carrying amount.
- ▶ A reduction in the margin of 100 basis points would have a negative impact of €800 million.

Danone, Annual Report 2009, page 120

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 judgment. 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.

The diversity of approaches taken can be displayed by the following quotes:

“Any impairment losses are recorded in ‘Other non-recurring operating income and expenses’ in the consolidated income statement as part of operating income.”

PPR, Annual Report 2009, page 96

“Intangible amortisation and impairment are included within administrative and other expenses in the consolidated income statement.”

Imperial Tobacco Group, Annual Report 2009, page 93

Key findings

Brands and goodwill represent significant economic value for CP entities – in some instances, they amount to over 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 both for brand as well as for 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 assumptions 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 CP 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.

Compared to 2008, impairment losses did not increase notably and remain at low levels. The impact of the financial crisis does not appear to be significant with regard to goodwill and brand valuation.



Hedge accounting: complexity reduces applicability

Hedge accounting and the accounting for derivative financial instruments are often considered the most complex issues within IFRS. Although hedging policies and risk management practices are commonly used, CP entities generally do not reflect this in financial reporting because the requirements in IAS 39 are not met.

CP entities often use dollar-traded commodities in their production processes or acquire other goods in foreign currencies. Interest rate risks 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 the 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.

Tough criteria limit use

To qualify for hedge accounting under IAS 39 all of the following conditions have to be met and demonstrated:

- ▶ Formal designation and documentation of the hedging relationship, the entity's risk management objective and strategy for undertaking the hedge at the inception of the hedge.
- ▶ Hedge is expected to be highly effective (range from 80% to 125%).
- ▶ Highly probable forecast transaction presenting an exposure to variations in cash flows that could ultimately affect net profit or loss.
- ▶ Effectiveness can be reliably measured.
- ▶ Assessment of hedge effectiveness on an ongoing basis throughout the financial reporting periods for which the hedge was designated.

Although most entities use derivative financial instruments specifically for risk management, in many cases hedge accounting is not applied as the conditions of IAS39 are not met.

SABMiller describes its hedge accounting policy as follows:

"Certain derivative instruments, while providing effective economic hedges under the group's policies, are not designated as hedges. Changes in the fair value of any derivative instruments that do not qualify or have not been designated as hedges are recognised immediately in the income statement. The group does not hold or issue derivative financial instruments for speculative purposes."

SABMiller, Annual Report 2009, page 83

Henkel also states that use of hedge accounting is limited:

"All derivative financial instruments entered into by the Group are measured initially at cost and subsequently at their fair values on the balance sheet date. The accounting treatment of gains and losses on remeasurement to fair value depends on whether the conditions set out in IAS 39 with respect to hedge accounting have been met.

Hedge accounting is not used for the majority of derivative financial instruments. The changes in the fair value of those derivatives which, from an economic point of view, represent effective hedges in line with the corporate strategy are recognized in profit or loss. These are virtually matched by changes in the fair value of the hedged underlying transactions."

Henkel KGaA, Annual Report 2009, page 113

Swedish Match has decided not to apply hedge accounting in 2009/2010:

"Swedish Match policy for managing the Group's transaction exposure is to hedge within certain limits. The hedging transactions are, if any, based on risk exposures, current market conditions and other strategic considerations. Transactions are mainly initiated via currency forward



contracts with durations of up to 12 months, and relate to forecasted currency flows. At December 31, 2009, the exposure was limited and therefore no transaction exposure for 2010 has been hedged.”

Swedish Match, Annual Report 2009, page 80.

Commodity risk management

Some CP entities are 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 mitigated in a number of ways. Long-term supplier contracts, 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.

Commodity financing agreements are arrangements in which an intermediary physically purchases the required commodities and stores them on its own account until physical delivery to the counterparty takes place. These agreements are favourable in circumstances where the physical access to commodities in a desired quality, quantity and location is important. Other instruments that might be settled in cash may not guarantee physical access. Similarly, long-term purchase contracts do not always secure delivery, as availabilities are not secured. Commodity financing agreements, however, are either not used or not disclosed by the entities surveyed.

Commodity contracts that are settled in cash are within the scope of IAS 39 and are accounted for as derivative financial instruments at fair value through the profit and loss account or as a financial instrument in an effective hedge relationship.

The majority of CP entities managing commodity price risk use arrangements within the scope of IAS 39. Four CP 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 2009, page 109

Heineken has taken a similar approach, but commodity hedging is limited as follows:

“The main commodity exposure relates to the purchase of cans, glass bottles, malt and utilities. Commodity risk is in principal addressed by negotiating fixed prices in supplier contracts with various contract durations. So far, commodity hedging with financial counterparties by the Company is limited to the incidental sale of surplus CO2 emission rights and aluminium hedging, which is done in accordance with risk policies. Heineken does not enter into commodity contracts other than to meet Heineken’s expected usage and sale requirements. As at 31 December 2009, the underlying amount of aluminium swaps was EUR 8 million.”

Heineken, Annual Report 2009, page 139

Nestlé explains:

“The commodity price risk exposure of anticipated future purchases is managed using a combination of derivatives (futures and options) and executory contracts (differentials and ratios). The vast majority of these contracts are for physical delivery, while cash-settled contracts are treated as undesignated derivatives.”

Nestlé, Annual Report 2009, page 102

Scant disclosure on hedge effectiveness

The assessment of hedge effectiveness requires a dual test:

- ▶ There must be an expectation that the hedge will be effective (the prospective test)
- ▶ It must be demonstrated that the hedge has actually been effective (the retrospective test)

Assessment of hedge effectiveness may involve the use of complex statistical techniques and valuation models. 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 CP 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.

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 2009, page 108

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.

However, IAS 39 provides several exemption clauses. **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 2009/2010, page 80

Key findings

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

Although most CP entities in our survey are involved in some economic hedging, not all CP entities apply hedge accounting in their financial reporting, due to either the strict requirements of IAS 39 or to the administrative burden of hedge accounting and documentation requirements.

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

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

Only a few CP entities provide information on the 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.

For fiscal years beginning on or after 1 January 2009, 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 judgment.

Almost all the surveyed CP entities disclose which level of the fair value hierarchy has been used to arrive at fair values for their financial instruments.

Henkel, for example, has disclosed the following:

“The fair values of marketable securities are based exclusively on quoted market prices (level 1 of the fair value hierarchy). No fair values are assigned to levels 2 and 3 of the fair value hierarchy.”

Henkel, Annual Report 2009, page 113

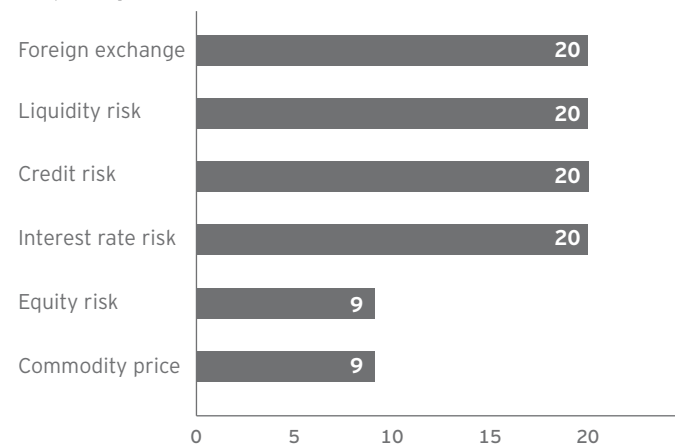
And **Swedish Match** states:

“All items valued at fair value in the balance sheet are considered to be included in level 2 within the fair value hierarchy presented in IFRS 7. The values presented are indicative and may not necessarily be realized.”

Swedish Match, Annual Report 2009, page 82

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.

Frequency of risk factors considered



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.

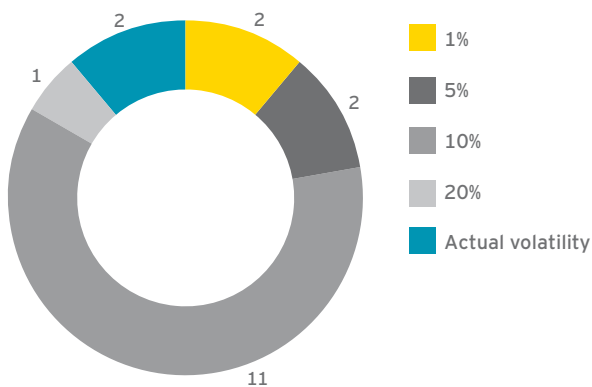
The need for sensitivity

Those CP 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 CP 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 their interactions. Sensitivity analysis allows the individual assessment of risk factors under chosen variations.

Variations used for forex risk sensitivity analysis



The majority of CP entities use a 10% variation as an approximation for foreign exchange volatility, although two entities used actual volatilities instead. (The CP 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 2009 were between 2.8% and 5.2% of the average exchange rate during the calendar year 2009.

Most CP entities in our survey apply sensitivity analysis for interest rate risk. Only one CP entity uses actual volatilities, while **Nestlé** presents a VaR analysis. In 2009, four CP entities used a 50 bp variation as an approximation of interest rate volatility (compared with only one in 2008). All other entities used a 100 bp variation.

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

Surprising lack of quantitative commodity risk analysis

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

Danone presents the following detailed information, complemented by a table, which shows that a 5% increase or decrease in the prices of liquid milk, powdered milk and other milk-based ingredients would result in a gain or loss of 90 million euros:

“In addition, with respect to the Group’s primary raw material category, a sensitivity analysis of changes in milk prices on the Group’s annual purchasing costs (applied simultaneously in all countries where the Group has production activities) is presented in Section 20.1.1, Note 15 relative to IFRS 7.”

The table below measures the impact of changes in the annual cost of purchases of milk and milk-based ingredients (1) on the Group’s operating earnings for 2009 and 2008, assuming a 5% increase or decrease the prices for these items, simultaneously in all countries where the Group has production activities, for each fiscal year presented.”

Danone, Annual Report 2009, page 133

Key findings

All CP entities in our survey disclose foreign exchange risk, interest rate risk, liquidity risk, and credit risk as significant risk factors. Only some CP entities present equity risks and commodity price risks as significant risk factors.

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

Variations used for sensitivity analysis are regularly comparable to observable market volatilities. A 50 bp or 100 bp variation has developed as an implicit reporting standard for interest rate risks. Variations in respect to equity prices and foreign exchange risks are less uniform among the CP entities surveyed.



Segment reporting: linking disclosure with internal reporting

IFRS 8 *Operating Segments* replaced IAS 14 *Segment Reporting* for annual periods beginning on or after 1 January 2009.

IFRS 8 requires that segment information reported be the same as that with the chief operating decision-maker uses internally, for evaluating the performance of segments. When this information is not prepared in accordance with IFRS, entities must provide explanations and reconciliations of the differences.

In our survey, four entities are applying IFRS 8 for the second year and **Henkel** is the only entity applying IFRS 8 for the third year in 2009.

Many of the surveyed entities still present sales and other financial figures by product area or brand and geographic areas, comparable to the previous presentation of primary and secondary segments according to IAS 14. IFRS 8 replaces the detailed geographic information required by IAS 14 and requires instead disclosure of sales revenue for each group of homogeneous products and services. Geographic segmentation is no longer necessary, except for material revenues attributed to a specific foreign country, which are disclosed separately.

Linking financial segment reporting with an entity's internal management reporting leads to a range of different approaches being used. **PPR** applies a segmentation following its major brands and presents data prepared according to IFRS principles. **Reckitt Benckiser Group** provides segmentation based on geographical considerations for all business segments, other than the global pharmaceutical business, which is presented on a stand-alone basis alongside the geographical segments. **Henkel** presents both business segments and geographical segments.

The majority of entities have adopted IFRS 8 without any changes regarding the presentation of segment information compared with IAS 14. Only four entities have made restatements when adopting IFRS 8; these are **adidas**, **Richemont**, **SABMiller** and **Nestlé**.

Slicing the pie in a different way

adidas has now combined results for its adidas and Reebok brands under Wholesale and Retail. This is not only a consequence of the implementation of IFRS 8, but is also based on the strategic decision to "move from a vertically integrated brand structure into a functional multi-brand structure for the adidas and Reebok brands" (adidas, Annual Report 2009, page 52).

Richemont has combined the financial performance of some segments together in the Other category and has replaced the information on net segment assets with information on inventories and trade receivables.

SABMiller now presents Africa and Asia as two separate segments and **Nestlé** has aggregated globally managed businesses that do not meet the quantitative thresholds of reportable segments under IFRS 8. **Nestlé** describes its approach as follows:

"The Group is focused in two areas of activity, Food and Beverages, and Pharmaceuticals. The Group's Food and Beverages business is managed through three geographic Zones and several Globally Managed Businesses (GMBs). Zones and GMBs, that meet the quantitative threshold of 10% of sales, EBIT or assets, are presented on a standalone basis as reportable segments. Other GMBs that do not meet the threshold, like Nestlé Professional, Nespresso, and the food and beverages Joint Ventures, are aggregated and presented in Other Food and Beverages. The Group's pharmaceutical activities are also managed, and presented, separately. Therefore, the Group's reportable operating segments are:

- ▶ Zone Europe
- ▶ Zone Americas
- ▶ Zone Asia, Oceania and Africa
- ▶ Nestlé Waters
- ▶ Nestlé Nutrition
- ▶ Other Food and Beverages
- ▶ Pharma

As some operating segments represent geographic zones, information by product is also disclosed. The eight product groups that are disclosed represent the highest categories of products that are followed internally."

Nestlé, Annual Report 2009, page 52

Two entities still apply IAS 14 as they are not yet required to apply IFRS 8. **Diageo** states the impact is still under assessment and **Pernod Ricard** states no major impact is expected.

Early adopter

SABMiller points out that some of its reporting segments do not meet the criteria as set out in IFRS 8 (but nonetheless provides additional and useful information). Furthermore, **SABMiller** has adopted early the amendment to IFRS 8 which specifies that the disclosure of total assets by operating segment is only required if these figures are regularly reported to and controlled by the responsible Group management:

“IFRS 8, ‘Operating Segments’ requires separate reporting of segmental information for operating segments. Operating segments reflect the management structure of the group and the way performance is evaluated and resources allocated based on group revenue and EBITA by the group’s chief operating decision maker, defined as the executive directors. The group is focused geographically and as a result of the implementation of IFRS 8, Africa and Asia are now presented as separate segments. Comparative information has been restated accordingly. While not meeting the definition of reportable segments, the group reports separately as segments Asia, South Africa Hotels and Gaming and Corporate as this provides useful additional information.

On 23 March 2010, the EU endorsed Annual Improvements to IFRSs (2009), which included an amendment to the disclosures required by IFRS 8, ‘Operating Segments’. Although only mandatory for periods beginning on or after 1 January 2010, the group has chosen to adopt this amendment early. Following the implementation of IFRS 8 and the early adoption of the subsequent amendment, the group no longer discloses segment assets or liabilities, as these are not reported to the group’s chief operating decision maker.”

SABMiller, Annual Report 2009/2010, page 75

CP entity	Operating segments
adidas	Wholesale Retail Taylor made - adidas Golf Rockport Reebok - CCM Hockey Other centrally managed brands
Anheuser-Busch InBev	North America Latin America North Latin America South Western Europe Central & Eastern Europe Asia Pacific Global Export
Beiersdorf	Consumer tesa
British American Tobacco	Asia-Pacific America Eastern Europe Western Europe Africa and Middle East
Christian Dior	Christian Dior couture Wines and spirit Fashion and leather goods Perfumes and cosmetics Watches and jewellery Selective retailing Other and holding entities
Compagnie Financière	Jewellery Specialist watchmakers Writing instruments Other
Danone	Fresh dairy products Waters Baby nutrition Medical nutrition
Heineken	Western Europe Central and Eastern Europe The Americas Africa and the Middle East Asia Pacific Head office/eliminations



CP entity	Operating segments
Henkel	Laundry and home care Cosmetics and toiletries Adhesives for craftsmen and consumers Industrial adhesives Corporate
Imperial Tobacco Group	Tobacco logistics
L'Oréal	Cosmetic branch: ▶ Professional products ▶ CP ▶ Luxury products ▶ Active cosmetics The Body Shop branch Dermatology branch
Nestlé	Zone Europe Zone Americas Zone Asia, Oceania and Africa Nestlé Waters Nestlé Nutrition Other food and beverages Pharma
PPR	Conforama Fnac Redcats Cfao Puma Gucci Bottega Veneta Yves Saint Laurent Other brands
Reckitt Benckiser	Europe NNA (North America, Australia and New Zealand) Developing Markets RBP (Pharmaceuticals)
SABMiller	Latin America Europe North America Africa Asia South Africa
Swatch Group	Watches and jewellery Production Electronic systems Corporate

CP entity	Operating segments
Swedish Match	Snus and snuff Chewing tobacco Cigars Lights Other operations
Unilever	Asia Africa Central Eastern Europe America and Western Europe

Key findings

The majority of CP entities have adopted IFRS 8 without any changes to the segments previously identified under IAS 14.

When grouping the CP entities by product category, most beverages entities are managed based on geographic operating segments, while luxury and apparel entities are managed based on the financial performance of brands/product groups. Entities with a focus on other product categories (food, tobacco, household and personal care) present different operating segments; some CP entities also use a combination of both geographic- and product-related reportable segments.



Other issues

Advertising costs: timing is of the essence

CP entities typically spend significant amounts on advertising and promotional activities. Our publication *Advertising and Sponsorship: Accounting for promotional costs in CP entities under IFRS¹¹* considers the accounting treatment for these costs in light of amendments to IAS 38 *Intangible Assets* issued in June 2010 by the IASB about the timing of the recognition of advertising and promotional costs.

We have highlighted here some examples of how the clarifications have impacted some CP entities. The **Swatch Group** explicitly states that the amendment to IAS 38 did not give rise to a restatement. However, **PPR** has reclassified advertising costs due to the amendment:

“The amendment to IAS 38 requires all expenditure for advertising and promotional activities to be expensed when incurred. An expense must be recognised when entities have a right to access the goods or, in the case of the supply of services, as soon as the services have been provided. Costs relating to the production of mail order catalogues are explicitly classified as expenditure for advertising and promotional activities, and therefore fall within the standard’s scope of application.

Expenditure incurred in creating, producing and preparing mail order catalogues was previously expensed as of the date the catalogues were sent to customers, and costs for catalogues not yet sent were recognised in prepaid expenses until such date.

Accordingly, these costs together with expenditure for advertising and promotional activities have been reclassified to the periods in which they were incurred, in accordance with the amended standard.”

PPR, Annual Report 2009, page 103

Christian Dior describes the changes as follows:

“Impacts of the amendment to IAS 38 Intangible assets

As of fiscal year 2009, advertising and promotion expenses are recorded upon the receipt or production of goods or upon completion of services rendered. Previously, such costs were recognized as expenses for the period in which they were incurred, the cost of media campaigns in particular was time apportioned over the duration of these campaigns and the cost of samples and catalogs was recognized when they were made available to customers. The impact of this change in accounting policy on consolidated equity amounts to 94 million euros as of January 1, 2007.”

Christian Dior, Annual Report 2009, page 100

Defined benefit plans: the end of the corridor?

The IASB published an exposure draft, *Defined Benefit Plans (proposed amendments to IAS 19)*, in April 2010, to address major changes in accounting for long-term employee benefits such as pensions.

The most significant proposal is the removal of the “corridor mechanism.” The current corridor mechanism allows entities to defer certain actuarial gains and losses from the measurement of defined benefit obligations and thus to reduce the volatility in financial reporting.

Seven of the 20 CP entities surveyed (35%) account for pension obligations using the corridor mechanism. According to the proposed changes, entities that still use the corridor mechanism will be required to recognise all changes in the value of defined benefit obligations, including the actuarial gains and losses, as they occur. This will introduce greater volatility into net assets, with potential consequences for debt covenant ratios and other target ratios.

Other changes introduced by the new proposals will also impact some CP entities in the survey, which currently recognise actuarial gains and losses directly in other comprehensive income.

¹¹www.ey.com/publication *Advertising and Sponsorship: Accounting for promotional costs in CP entities under IFRS*



“Remeasurements” will now be recorded in other comprehensive income. These are all components currently described as actuarial gains and losses. Finance costs (or credits) will be the product of the net balance sheet liability (or asset) and the discount rate used to measure the obligation.

New proposals will hit profits

Differences between the actual rate of return and the discount rate used will be recognised as part of the re-measurements in other comprehensive income. This change will lead in many cases to a reduction in profits because the expected return on assets based on their long-term yield is usually considerably higher than the discount rate applied in determining the post-employment benefit obligation.

For many of the surveyed CP entities, the expected rates of return on plan assets exceed the discount rate of the defined benefit obligation. While the expected rates of return on plan assets range from a minimum of around 4% to a maximum of 11%, with an average of approximately 7%, discount rates range from a minimum of around 1.5% to a maximum of 11%, with an average of approximately 5%.

Furthermore, the distinction between post-employment benefits and other long-term benefits will be removed according to the proposals. As a consequence, actuarial variances on all long-term benefits will be recorded in other comprehensive income. Thus all entities will be required to analyse their current accounting treatments of other long-term benefits (e.g., management bonus programs) and the consequences from the proposed changes. These changes may give entities the opportunity to structure incentive plans differently to minimise the impact on profit or loss. If the proposals are implemented, the management of long term incentive plans is likely to be a key area of interest in the financial statements.

The proposals will also change the treatment of past service costs, which will be recognised immediately in profit or loss rather than being amortised over the remaining vesting period.

The distinction between long-term and short-term benefits will also change under the proposals. The classification will be based on when an employee is expected to receive the benefit rather than when he or she becomes entitled to it. This may require changes to IT systems.

Different discount rates and rates of return on plan assets will be used depending on the type of asset (equities, bonds, properties, etc.), historical rates of returns, and market expectations in the countries concerned.

As **adidas** describes:

“Given the diverse Group structure, different defined benefit plans exist, comprising a variety of post-employment benefit arrangements. ... The actuarial assumptions for withdrawal rate and mortality rate are based on statistical information available in the various countries, the latter for Germany on the Heubeck 2005 G mortality tables. The Group recognises actuarial gains and losses arising in defined benefit plans during the financial year immediately outside the income statement in the consolidated statement of comprehensive income. The actuarial losses recognised in this statement for 2009 amount to €16 million (2008: positive €3 million). ...The expected return on plan assets assumption is set separately for the various benefit plans. The expected return on plan assets is determined for each asset category separately and generally based on capital market research and forecasted returns.”

(**adidas**, Annual Report 2009, pages 187-88)

A number of entities recognise actuarial gains and losses in the statement of other comprehensive income. **British American Tobacco** states in its 2009 annual reports:

“Actuarial gains and losses, changes in unrecognised scheme surpluses and minimum funding requirements are recognised in full through other comprehensive income.”

(**British American Tobacco**, Annual Report page 117)

L'Oréal has decided to change its approach and has adopted the IAS 19 option, which allows the recognition of actuarial gains and losses in equity, instead of the corridor method:

“The Group has decided to adopt as from January 1st, 2009, the IAS 19 option allowing the direct recognition in equity of actuarial gains and losses, instead of the corridor method. The charges recorded in the profit and loss account during the year include:

- ▶ Service cost, i.e., additional rights acquired by employees during the accounting period.
- ▶ Interest cost, i.e., change in the value of the discounted rights due to the fact that one year has gone.

- ▶ Expected return on assets, i.e., income from external assets calculated on the basis of a standard return on long-term investments.
- ▶ The impact of any change to existing schemes on previous years or of any new schemes. To determine the discounted value of the obligation for each scheme, the Group applies an actuarial valuation method based on the final salary (projected credit unit method). The obligations and the fair value of assets are assessed each year, using length-of-service, life expectancy, staff turnover by category and economic assumptions (such as inflation rate and discount rate).

Actuarial gains and losses in relation to other benefits, such as jubilees and medals, are immediately charged to the profit and loss account.”

(L'Oréal, Annual Report 2009, page 16)

Key findings

Seven of the 20 CP entities surveyed currently use the corridor mechanism to account for pensions. The proposed removal of the corridor mechanism means CP entities will have to recognise all changes in the fair value of defined benefit obligations, which will lead to an increased volatility of net assets.

The majority of CP entities state in their annual reports that the expected rate of return on assets is higher than the discount rate of the benefit obligation. This could lead to a reduction in profits, since the difference between the actual rate of return and the discount rate will be recognised in other comprehensive income.

Agency agreements with retailers: limited disclosure on revenue recognition

As we reported in our survey last year, many CP entities have established “shop-in-shop” concepts or other controlled retail spaces. As a result, these CP entities need to determine whether the revenue generated with end-customers in these controlled retail spaces should be presented either as gross (and the commission fee paid to the retailer expensed) or net as the sale price to the retailer.

The IASB amended the appendix to IAS 18 *Revenue* in April 2009 to include specific guidelines on how to determine whether an entity is acting as a principal or as an agent. This amendment is effective for annual periods beginning on or after 1 January 2010.

Mirroring the results of the 2008 survey, only a few CP entities provide information on their revenue recognition principles for agency relationships.

Christian Dior's policy is described as follows:

“Revenue mainly comprises direct sales to customers and sales through distributors. Sales made in stores owned by third parties are treated as retail transactions if the risks and rewards of ownership of the inventories are retained by the Group. Direct sales to customers are made through retail stores for fashion and leather goods, certain perfumes and cosmetics, certain watches and jewellery brands and selective retailing. These sales are recognised at the time of purchase by retail customers. Wholesale sales through distributors are made for wines and spirits, and certain perfumes and cosmetics and watches and jewellery brands. The Group recognises revenue when title transfers to third-party customers.”

Christian Dior, Annual Report 2008, page 103



In the future, the identification of agency agreements and the disclosure of their respective accounting treatment will continue to be an important issue for two reasons.

Firstly, we believe that CP entities will further increase their control over the distribution process up to the end sale to the consumer, in order to manage brand perception at the point of sales. This will lead to an increased use of shop-in-shop concepts, concessions stores, and even own retail stores. However, this effect will be different for the various CP sub-sectors. We expect comparatively lower efforts to control the distribution channels in the food, beverages and tobacco segments. The highest impact is expected in the apparel industry.

Secondly, the IASB amended IAS 18 in April 2009 with an effective date for fiscal years beginning on or after 1 January 2010. The Appendix of IAS 18 now includes specific guidelines on how to determine whether an entity is acting as a principal or as an agent.

Key findings

The entities surveyed rarely report on accounting for agency agreements with retailers. Increased control over the distribution process and concepts such as shop-in-shop concessions is likely to increase the identification of agency arrangements.

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

In August 2010 the IASB and the US Financial Accounting Standards Board (FASB) issued a joint exposure draft, *Leases*. The exposure draft proposes a single model that would be applied to most leases that would effectively end off-balance-sheet reporting for leases.

The proposed model would also require entities to make a number of estimates and periodically reassess those estimates in accounting for leases. As proposed, the standard would affect existing leases at transition and no leases would be grandfathered.

The following frequent criticisms of the current model will be addressed by the proposed changes:

- ▶ 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.

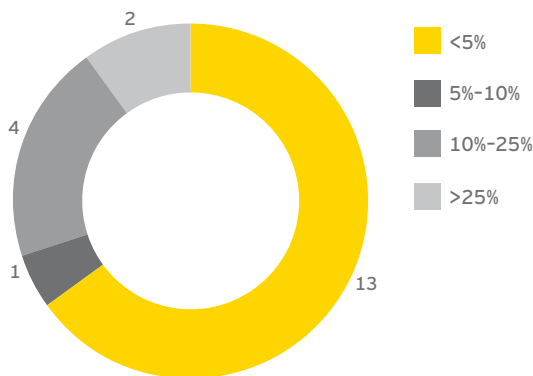
Based on the published disclosures of the future minimum lease payments on operating leases, we have prepared an approximation of the liabilities reported in the balance sheet under the new proposals for each of the CP entities surveyed. The discount rate used was 7% and lease payments and duration have been assumed constant from the second year onwards.

Due to the simplified assumptions we have made, this analysis provides only a rough indication of the potential impact of the new proposals. This analysis does not consider any contingent rentals 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 recognised, differ widely:

Approximated increase in liabilities on balance



While about two-thirds of entities surveyed need not expect an impact greater than 5% of their recognised liabilities, six entities would show an increase in recognised liabilities of more than 10%. Two entities need to prepare for an increase exceeding 25% of recognised liabilities.

Entities in the luxury and apparel sector will be particularly affected. These entities are often lessees of retail stores in exclusive and therefore expensive areas. The trend in certain industries is towards greater control over their products' value chain, but the proposed leasing model may impose difficulties on strategies that require leasing.

Entities that are likely to be significantly affected may 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.

The impact on lessee financial statements of the proposals will be:

- ▶ An increase in assets, lower asset turnover ratios and perhaps lower return on capital.
- ▶ An increase in current and non-current liabilities and an increase in the debt-to-equity ratio.
- ▶ Higher amortisation and interest expense instead of rent expense.
- ▶ Constant amortisation and declining interest expense over the anticipated lease term leading to an initially lower profit.

The exposure draft is open to public comment until 15 December 2010.

Revenue from contracts with customers

In June 2010, the IASB and the US FASB (collectively, the Boards) issued the Exposure Draft (ED) *Revenue from Contracts with Customers*. The proposed model provides the principles that entities should apply in determining the amount, timing and uncertainty of revenue recognition arising from contracts to provide goods and services to their customers.

Although the accounting for some transactions may not be significantly changed, it is likely that all entities will be affected by the proposed new standard. The proposals will also introduce more detailed guidance on the accounting for certain transactions, such as multiple-element arrangements, than is currently contained in IAS 18 *Revenue*.

The accounting for some components that are common to CP revenue transactions, including rights of return, product warranties, discounts and sales incentives, will also be affected by the proposed standard.

The model

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

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the separate performance obligations.
5. Recognise revenue when each performance obligation is satisfied.

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

Scope

The proposed standard will apply to all contracts with customers except:

- ▶ Lease contracts
- ▶ Insurance contracts
- ▶ Financial instruments
- ▶ Certain non-monetary transactions



Differences compared with current IFRS

IAS 18 focuses on revenue recognition upon the transfer of the “risks and rewards.” The proposed model will instead focus on the transfer of “control.” The proposed requirement to identify performance obligations and allocate the transaction consideration to those performance obligations based on their relative stand-alone selling prices provides greater guidance than currently included within IFRS.

Identify the contract with the customer

In order to apply the proposed revenue recognition model, an entity must first identify the contract(s). The proposed standard indicates that contracts may be written, verbal or implied, and that the entity’s business practices may influence its determination of whether or not a contract exists.

The ED also indicates that while in most cases the requirements will be applied to a single contract with a customer, there may be situations where the entity should either combine multiple contracts or divide a single contract into segments for purposes of revenue recognition.

Identify the separate performance obligations

Under the proposed model, the entity evaluates the terms of the contract as well as the entity’s normal business practices to identify all promised goods and services. For example, an established business practice of providing warranty coverage for 90 days is likely to represent a promised service, even if a contract with a customer does not explicitly provide for warranty claims.

An entity must determine if promised goods and services should be treated as separate performance obligations. The proposed model indicates that promised goods and services should only be treated as separate performance obligations if the good or service is “distinct” – that is, either:

- ▶ The entity, or another entity, sells an identical or similar good or service separately.
- ▶ The entity could sell the good or service separately because it meets both of the following conditions:
 - ▶ The good or service provides utility either on its own or together with other goods and services available in the marketplace (from other entities).
 - ▶ It has a distinct profit margin, evidenced by distinct risks, and the entity can separately identify the resource needed to provide the good or service.

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. Under the proposed model, the obligation related to warranties results in an initial deferral of revenue, which is then recognised as the warranty services are provided. Costs associated with fulfilling warranty obligations would be expensed as incurred.

The proposed model distinguishes between two types of warranty. Warranties that cover latent defects in products that existed when the goods were transferred to the customer are not likely to be separate performance obligations. In these situations, the entity should assess whether it has satisfied its performance obligation to deliver the good or service. Conversely, warranties that cover defects that arise after a customer has taken control of a good are separate performance obligations.

Both types of warranties, however, will result in an amount of revenue being deferred. For warranties designed to cover latent defects, entities should defer revenue for the products (or portions of products) estimated to have latent defects. Revenue is then recognised when control of the product is deemed to have transferred. When the warranty is considered a separate performance obligation, the revenue allocated to the warranty services is deferred and recognised as the warranty services are performed.

Determine the transaction price

The proposed standard defines transaction price as “the amount of consideration an entity receives, or expects to receive, from a customer in exchange for transferring goods or services excluding amounts collected on behalf of third parties (for example, taxes).” In many cases, this is readily determinable, as the price is fixed and payment is received at approximately the same time the entity transfers control of the promised goods or services.

For some transactions, however, portions of the transaction price may be variable (e.g., early settlement discounts). For those transactions, the proposed model provides that an entity must recognise revenue based on the estimated transaction price, if the entity has the ability to make reasonable estimates.

In determining the transaction price, the entity must also consider the effects of collectability (i.e., customer credit risk) and consideration paid to a customer. For example, the proposed model requires the entity to assess, upon satisfaction of the performance obligation, the expected consideration to be collected using a probability-weighted approach. That amount is then used in determining the total transaction price. Any subsequent changes in the amount expected to be collected or actually collected should be recognised in other income or expense (i.e., separate from revenue). Adjusting the transaction price for these items will be a major change from current practice.

Allocate transaction price to the separate performance obligations

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

If the price of a good or service sold separately is not readily observable, the entity estimates the amount for which it would sell each performance obligation on a standalone basis, such as “expected cost plus a margin.”

Recognise 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.”

For most CP entities, the determination of when the customer obtains control is relatively straightforward and the proposed model includes the following indicators that the customer has obtained control:

- ▶ The customer has an unconditional obligation to pay for the good or service.
- ▶ The customer has legal title to the good or service.
- ▶ The customer has physical possession of the good or service.
- ▶ The design or function of the good or service is customer-specific such that the good or service might be of little value to the entity because it lacks an alternative use.

The timing of revenue recognition is directly related to the determination of when control of a promised good or service has been transferred to the customer. So for delivery of promised goods, the entity would likely recognise revenue once the goods have transferred to the customer.



Appendix

Risks identified in the surveyed financial statements



Risk	adidas	Beiersdorf/ Tchibo	BAT	LVMH/ Christian Dior	Diageo	Groupe Danone	Heineken	Henkel
Recession, changes in consumer preferences	x	x	x		x	x	x	x
Competition	x		x	x	x	x		x
Other economic, social, political uncertainties			x		x		x	
Increased social and political attention to industry (environmental issues, ingredients, labour standards, sourcing)					x	x		
Seasonality				x		x		
Customer consolidation and growth of discounters	x	x				x		
Customers may limit brands or not actively promote brands				x				x
Continued product innovation, failure to ensure relevance, attractiveness of brands	x	x	x	x		x	x	
Reputation	x			x		x	x	
Development and maintenance of talent	x				x			x
Inability to predict consumers' changing behaviour	x	x	x			x		
Exposure to D&E markets								
Failure to integrate acquisitions						x	x	
Consolidation in sector: failure to participate in transactions may inhibit ability to grow/exploit scale benefits	x							
Ability to pursue successful strategies (including pricing), reorganisations			x		x		x	
Maintain good relationships with stakeholders/ partners	x			x				
Failure to deliver on published targets	x							
Missed or wrongly valued acquisitions			x			x		
Risk	adidas	Beiersdorf/ Tchibo	BAT	LVMH/ Christian Dior	Diageo	Groupe Danone	Heineken	Henkel
Supply shortages, increased prices	x	x	x	x	x	x	x	x
Product quality and safety: ingredients, contamination	x	x		x	x	x	x	
Supply chain disruption, natural disasters, terrorism, etc.	x	x	x			x		x
IT risks and security	x		x	x	x	x	x	x
Realisation of projected benefits from initiatives			x		x		x	
Health and safety of employees		x				x		
Labour relations								
Pension obligations			x					x
Foreign exchange risk	x	x	x	x	x	x	x	x
Interest rate risk			x	x	x	x		x
Liquidity risk	x	x	x		x	x		
Inflation: commodity price risk, raw materials, energy prices, wages	x		x		x		x	x
Credit risk	x				x			x
Investment success: equities, pension funds					x	x		x
Counterparty risks (banks, suppliers, insurance companies, customers)	x	x	x	x		x		x
Funding in capital markets	x		x				x	
Debt burden								
Derivative financial instruments								x
Regulatory constraints on products, imports and exports; taxes and duties	x		x	x	x	x	x	x
Litigation regulation, industry and operational issues	x		x		x	x	x	x
Protection of intellectual property rights	x			x	x	x		
Regulation changes: labelling, distribution, advertising, environmental issues, health agenda			x		x			

Imperial Tobacco Group	Anheuser Busch Inbev	L'Oreal	Nestlé	Pernod Ricard	PPR	Reckitt	Richemont	SABMiller	Swatch Group	Swedish Match	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									
Imperial Tobacco Group	Anheuser Busch Inbev	L'Oreal	Nestlé	Pernod Ricard	PPR	Reckitt	Richemont	SABMiller	Swatch Group	Swedish Match	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
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