

# Technical Line

FASB – final guidance

## How the new revenue standard affects retail and consumer products entities

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### What you need to know

- ▶ Many retail and consumer products entities have had to change their accounting for promotional and loyalty programs (e.g., loyalty points and gift cards issued as a promotion) because, under the standard, these customer options to acquire additional goods and services may provide material rights to customers.
- ▶ If third parties are involved in providing goods or services to a customer, entities will need to perform a different analysis and may reach different conclusions about whether they are acting as a principal or an agent than they did under legacy GAAP.
- ▶ Many entities have found that implementation requires significantly more effort than they expected, including changes to their accounting processes and systems and/or internal controls.
- ▶ This publication has been updated to address considerations for private label and co-branded credit card arrangements.

### Overview

The new revenue recognition standard<sup>1</sup> issued by the Financial Accounting Standards Board (FASB or Board) requires entities in the retail and consumer products industry to make additional judgments and estimates, such as which options provide material rights to customers.

This publication highlights key aspects of applying the FASB's standard to a retail and consumer products entity's contracts with its customers, addresses certain changes to legacy practice and reflects the latest implementation insights.

As a reminder, the FASB deferred<sup>2</sup> the effective date to annual periods beginning after 15 December 2019 and interim periods in annual periods beginning after 15 December 2020, for entities that had not yet issued (or made available for issuance) financial statements that reflected the standard as of 3 June 2020 (i.e., certain private and not-for-profit entities). Early adoption is permitted. The deferral is intended to give these entities more time to implement the standard, given the operational and financial reporting challenges of the COVID-19 pandemic. Public entities, as defined by the standard, and some private and not-for-profit entities were already required to adopt the standard.

This publication, which contains a summary of the standard in the appendix, supplements our Financial reporting developments (FRD) publication, ***Revenue from contracts with customers (ASC 606)***, and should be read in conjunction with it. The views we express in this publication may continue to evolve as implementation continues and additional issues are identified.

Retail and consumer products entities should also keep in mind that, when they adopt the new credit impairment standard,<sup>3</sup> they will need to estimate full lifetime expected credit losses for their accounts receivable and contract assets. As a reminder, they will need to do this after assessing collectibility under the revenue guidance to determine whether they have a contract with a customer. Refer to our FRD publication, ***Credit impairment for short-term receivables under ASC 326***, for more information.

## Customer options for additional goods and services

Retail and consumer products entities frequently give customers the option to acquire additional goods or services. These additional goods and services may be priced at a discount or may even be offered free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives (e.g., discount vouchers or gift cards issued in conjunction with a current purchase that may be used to purchase goods or services at the entity's store or website in the future), volume-tiered pricing structures, customer award credits (e.g., loyalty or reward programs) or contract renewal options (e.g., waiver of certain fees, reduced future rates).

Under the standard, an option to acquire additional goods or services is a separate performance obligation in a contract with a customer only if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

The Board indicated in the Background Information and Basis for Conclusions of Accounting Standards Update (ASU) 2014-09<sup>4</sup> that the purpose of this guidance is to identify and account for options that customers are paying for (often implicitly) as part of the initial transaction. If the option provides a material right to the customer, the entity is required to allocate a portion of the transaction price to the material right at contract inception. The revenue allocated to the material right is recognized when (or as) the option is exercised (and the underlying future goods or services are transferred) or when the option expires. In contrast, if a customer option is not deemed to be a material right and is instead a marketing offer, there is no accounting for the option and no accounting for the underlying goods or services until those subsequent purchases occur.

The FASB did not provide any bright lines about what constitutes a "material" right. However, the guidance states that an option to purchase additional goods or services at their standalone selling prices does not provide a material right and is instead a marketing offer.

Members of the Transition Resource Group for Revenue Recognition (TRG) generally agreed<sup>5</sup> that entities should consider all relevant transactions with a customer (i.e., current, past and future transactions), including those that provide accumulating incentives such as loyalty programs, when determining whether an option represents a material right. That is, the evaluation should not be performed only in relation to the current transaction.

The following example summarizes Example 49 in the standard<sup>6</sup> and illustrates the accounting for an option that provides the customer with a material right.

#### Illustration 1 – Coupon that provides the customer with a material right

An entity enters into a contract for the sale of Product A for \$100. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to \$100 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

Because all customers will receive a 10% discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10% (that is, the additional 30% discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

To estimate the standalone selling price of the discount voucher in accordance with ASC 606-10-55-44, the entity estimates an 80% likelihood that a customer will redeem the voucher and that a customer will, on average, purchase \$50 of additional products. Consequently, the entity's estimated standalone selling price of the discount voucher is \$12 (\$50 average purchase price of additional products × 30% incremental discount × 80% likelihood of exercising the option). The standalone selling prices of Product A and the discount voucher and the resulting allocation of the \$100 transaction price are as follows:

Performance obligation	Standalone selling price
Product A	\$ 100
Discount voucher	\$ 12
Total	\$ 112

The entity allocates \$89 (\$100 / \$112 × \$100) to Product A and recognizes revenue for Product A when control transfers. The entity allocates \$11 (\$12 / \$112 × \$100) to the discount voucher and recognizes revenue for the voucher when the customer redeems it for goods or services or when it expires.

Entities that historically applied the incremental cost method to account for customer loyalty or reward programs have had to change how they account for these programs.

#### Loyalty or reward programs

Retail and consumer products entities frequently offer loyalty or reward programs under which customers accumulate points that they can redeem for “free” or discounted products or services. Under the standard, an entity typically concludes that a loyalty or reward program provides a material right to customers that they would not receive without entering into a contract. A loyalty or reward program that provides a material right is identified as a performance obligation for purposes of revenue recognition.

Retail and consumer products entities need to defer revenue for a loyalty or reward program that provides a material right until the future good or service is provided (i.e., when the loyalty points are redeemed and the performance obligation is satisfied) or the option expires. Example 52 in the standard<sup>7</sup> illustrates that an entity should routinely refine and evaluate its estimate of how many points it expects to be redeemed at each reporting period.

#### How we see it

Retail and consumer products entities that applied the incremental cost method to account for customer loyalty or reward programs under legacy GAAP have had to change how they account for these programs. Under the incremental cost method, entities recognize revenue at the time of the initial sale and accrue the estimated costs of customer award credits from the loyalty or reward program. Under ASC 606, entities defer a portion of the revenue using the relative standalone selling price method.

## Volume discounts

Consumer products entities may provide incentives to their customers through volume discounts. These discounts can take different forms, such as tiered pricing (e.g., discounted pricing on future purchases over a certain volume level) or a discount that applies to all purchases under the agreement (e.g., discounted pricing on a retrospective basis once a certain volume level is met). We believe a volume rebate or discount that is applied retrospectively should be accounted for as variable consideration. This is because the final price of each good or service sold depends on the customer's total purchases subject to the rebate program. That is, the consideration is contingent upon the occurrence or nonoccurrence of future events. This view is consistent with Example 24 in the standard.<sup>8</sup>

Generally, if a volume rebate or discount is applied prospectively, we believe the rebate or discount would be accounted for as a customer option (not variable consideration). This is because the consideration for the goods or services in the present contract is not contingent upon or affected by any future purchases. Rather, the discounts available from the rebate program affect the price of future purchases. Entities need to evaluate whether the volume rebate or discount provides the customer with an option to purchase goods or services in the future at a discount that represents a material right (and is therefore accounted for as a performance obligation).

As stated above, the purpose of the material rights guidance is to identify and account for options that customers are paying for (often implicitly) as part of the current transaction. FASB TRG<sup>9</sup> members generally agreed<sup>10</sup> that in making this evaluation, an entity should first evaluate whether the option exists independently of the existing contract. That is, would the entity offer the same pricing to a similar high-volume customer independent of a prior contract with the entity? If yes, that indicates that the volume discount is not a material right as it is not incremental to the discount typically offered to a similar high-volume customer. If the entity would typically charge a higher price to a similar customer, that might indicate that the volume discount is a material right as the discount is incremental.

The following illustration summarizes a TRG agenda paper<sup>10</sup> example of evaluating whether a prospective volume discount gives rise to a material right.

### Illustration 2 – Volume discounts

Entity enters into a long-term master service agreement (MSA) with Customer A to provide an unspecified volume of non-customized parts. The price of the parts in subsequent years is dependent on Customer A's purchases in the current year. That is, Entity charges Customer A \$1.00 per part in year one, and if Customer A purchases more than 100,000 parts, its year two price will be \$.90.

When making the determination of whether the contract between Entity and Customer A includes a material right, Entity first evaluates whether the option provided to Customer A exists independently of the existing contract. To do this, Entity should compare the discount offered to Customer A with the discount typically offered to a similar high-volume customer that receives a discount independent of a prior contract with Entity. A similar customer could be Customer B, who places a single order with Entity for 105,000 parts. Comparing the price offered to Customer A in year two with offers to other customers that also receive pricing that is contingent on prior purchases would not help Entity determine whether Customer A would have been offered the year two price had it not entered into the original contract.

## How we see it

Consumer products entities need to carefully assess whether volume-tiered pricing in a sales agreement represents a material right that should be accounted for as a separate performance obligation. This evaluation often requires significant judgment.

### Estimating the standalone selling price of options

To allocate the transaction price between the goods and services sold and the option, retail and consumer products entities need to determine the option's standalone selling price. If the standalone selling price is not directly observable, the entity should estimate it, taking into consideration the discount the customer would receive in a standalone transaction and the likelihood that the customer would exercise the option.

The standard also provides an alternative to estimating the standalone selling price of an option. This practical alternative applies when the goods or services are both (1) similar to the original goods and services in the contract (i.e., the entity continues to provide what it was already providing)<sup>11</sup> and (2) provided in accordance with the terms of the original contract. The standard indicates that this alternative generally applies to options for contract renewals (i.e., the renewal option approach). Under this alternative, a portion of the transaction price is allocated to the option (i.e., the material right that is a performance obligation) by reference to the total goods or services expected to be provided to the customer (including expected renewals) and the corresponding expected consideration.

Retailers can grant multiple types of options to customers. We believe the form of an option should not affect how the standalone selling price is estimated. Consider, for example, a retailer that gives customers who spend more than \$100 during a specified period a \$15 discount on a future purchase in the form of a coupon or a gift card that expires two weeks from the sale date. If the retailer determines that this type of offer represents a material right, it will need to allocate a portion of the transaction price to the option on a relative standalone selling price basis.

The standard requires that an entity first look to any directly observable standalone selling price, which requires the entity to consider the nature of the underlying transaction. In this example, while a customer can purchase a \$15 gift card for face value, that transaction is not the same in substance as a transaction in which the customer is given a \$15 gift card or coupon in connection with purchasing another good or service. As such, we believe a retailer may determine that there is no directly observable standalone selling price for a "free" gift card or coupon obtained in connection with the purchase of another good or service.

The estimated standalone selling price for an option given in the form of a gift card or a coupon would be the same because both estimates would reflect the likelihood that the option will be exercised.

## How we see it

Entities that provide material rights to customers need processes and systems to track these customer options, estimate the standalone selling price of the options and allocate the transaction price to the current purchases and option based on that estimate. This has required entities to change their processes and internal controls.

## Consideration paid or payable to a customer

Many wholesale and consumer products entities make payments to their customers. The standard states that an entity should account for the consideration payable to a customer, regardless of whether the purchaser receiving the consideration is a direct or indirect customer of the entity. Consideration payable to a customer includes amounts payable to any purchasers of the entity's products at any point along the distribution chain. This would include entities that make payments to the customers of resellers or distributors that purchase directly from them (e.g., manufacturers of breakfast cereals offer coupons to consumers, even though their direct customers are the grocery stores that sell to consumers).

### Income statement classification

To determine the appropriate accounting treatment, an entity must first determine whether the consideration paid or payable to a customer is a payment for a distinct good or service, a reduction of the transaction price or a combination of both.

For a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct. However, if the payment to the customer is in excess of the fair value of the distinct good or service received, the entity must account for such excess as a reduction of the transaction price. If an entity cannot reasonably estimate the fair value of the good or service received from the customer, it is required to account for all of the consideration payable as a reduction in the transaction price.

Because consideration paid to a customer can take many different forms, entities have to carefully evaluate each transaction to determine the appropriate treatment of such amounts. Some common examples of consideration paid to a customer include:

- ▶ **Slotting fees** – Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Those shelves can be physical (i.e., in a building where the store is located) or virtual (i.e., they represent space in an internet reseller's online catalog). Generally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.
- ▶ **Cooperative advertising arrangements** – In some arrangements, an entity agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the entity's products. The determination of whether the payment from the entity is in exchange for a distinct good or service at fair value will depend on a careful analysis of the facts and circumstances of the contract.
- ▶ **Buy downs or margin/price protection** – An entity may agree to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the entity's products. Normally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.
- ▶ **Coupons and rebates** – An indirect customer of an entity may receive a refund of a portion of the purchase price of the product or service acquired by returning a form to the retailer or the entity. Generally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.
- ▶ **"Pay to play" arrangements** – In some arrangements, an entity pays an up-front fee to the customer in order to obtain a new contract. In most cases, these payments are not associated with any distinct good or service to be received from the customer and should be treated as a reduction of the transaction price.

Determining whether a good or service is "distinct" may result in an entity reaching a different conclusion than it did under legacy GAAP.

- ▶ **Purchase of goods or services** – Entities often enter into supplier-vendor arrangements with their customers in which the customers provide them with a distinct good or service. For example, a software entity may buy its office supplies from one of its software customers. In such situations, the entity has to carefully determine whether the payment made to the customer is solely for the goods and services received, or whether part of the payment is actually a reduction of the transaction price for the goods and services the entity is transferring to the customer.

### **Timing of recognition of consideration paid or payable to a customer**

If the consideration paid or payable to a customer is a discount or refund for goods or services provided to a customer, the guidance on consideration payable to a customer says this reduction of the transaction price (and thus revenue) should be recognized at the later of when the entity transfers the promised goods or services to the customer or when the entity promises to pay the consideration. For example, if goods subject to a discount through a coupon are already delivered to the retailers, the discount would be recognized when the coupons are issued. However, if a coupon is issued that can be used on a new line of products that have not yet been sold to retailers, the discount would be recognized upon sale of the product to a retailer.

Even if a sales incentive would result in a loss on the sale of the product or service, an entity would recognize a liability for that sales incentive at the later of when it recognizes revenue on the good or service or the date at which the sales incentive was offered. That is, an entity would not recognize the loss before either date. However, an entity would also need to consider whether the offer indicates an impairment of existing inventory under ASC 330.

To determine the appropriate timing of recognition of consideration payable to a customer, retail and consumer products entities also need to consider the guidance on variable consideration. That is, the standard's definition of variable consideration is broad and includes amounts such as coupons or other forms of credits that can be applied to the amounts owed to an entity by the customer.

The variable consideration guidance requires that all potential variable consideration be considered and reflected in the transaction price at inception and reassessed as the entity performs. In other words, if an entity has a history of providing this type of consideration to its customers, the guidance on estimating variable consideration would require that such amounts be considered at the inception of the contract, even if the entity has not yet provided or explicitly promised this consideration to the customer.

Members of the TRG generally agreed<sup>12</sup> that if an entity has historically provided or intends to provide this type of consideration to customers, the guidance on estimating variable consideration would require the entity to consider such amounts at the contract's inception when the transaction price is estimated, even if the entity has not yet provided or promised to provide this consideration to the customer. If the consideration paid or payable to a customer includes variable consideration in the form of a discount or refund for goods or services provided, an entity would use either the expected value method or most likely amount method to estimate the amount to which the entity expects to be entitled and apply the constraint to the estimate to determine the effect on the transaction price of the discount or refund. Refer to "Step 3: Determine the transaction price" in the appendix to this publication for additional guidance on the constraint on variable consideration.

## How we see it

The guidance for consideration payable to a customer in ASC 606 is similar to legacy GAAP. However, determining whether a good or service is “distinct” may result in an entity reaching a different conclusion than it did under legacy GAAP, which required the vendor to receive an “identifiable benefit” from the customer that was sufficiently separable from the customer’s purchases of the vendor’s products in order to treat the consideration payable to a customer as anything other than a reduction of revenue.

TRG members’ general agreement that entities need to consider the guidance on variable consideration to determine the appropriate timing of recognition of consideration payable to a customer has resulted in a change in practice for some entities. TRG members generally agreed that the “later of” guidance for consideration payable to a customer in the standard would be applied in more limited circumstances than under legacy GAAP.

### *Up-front payments to a customer*

Many wholesale and consumer products entities make up-front payments to their customers, such as in a “pay to play” arrangement. While the guidance on consideration payable to a customer clearly applies to payments to customers under current contracts, during implementation, some stakeholders raised questions about how to account for up-front payments to potential customers and payments that relate to both current and anticipated contracts. For example, an entity might make an up-front payment to a potential customer in anticipation of future purchases, and there may not yet be a contract under the standard.

FASB TRG members discussed two views<sup>13</sup> on the accounting for up-front payments in this situation. Under View A, an entity would recognize an asset for the up-front payment and reduce revenue as the related goods or services (or as the expected related goods or services) are transferred to the customer. As a result, the payment could be recognized in the income statement over a longer period than the contract term. Entities would determine the amortization period based on facts and circumstances and would assess the asset for recoverability using the principles in other asset impairment models in US GAAP. Under View B, entities would reduce revenue from the current contract by the amount of the payment. If there is no current contract, entities would recognize a payment immediately in the income statement.

FASB TRG members generally agreed that an entity will need to use the view that best reflects the substance and economics of the payment to the customer and won’t be able to make an accounting policy election. Entities would evaluate the nature of the payment, the rights and obligations under the contract and whether the payment meets the definition of an asset. Some FASB TRG members noted that this evaluation was consistent with legacy US GAAP accounting for payments to customers and therefore similar conclusions may be reached under ASC 606. FASB TRG members also said an entity’s decision on which approach is appropriate may be a significant judgment in the determination of the transaction price that would require disclosure under ASC 606.

## How we see it

We believe an entity has to carefully evaluate all facts and circumstances of payments made to customers to determine the appropriate accounting. However, if an entity expects to generate future revenue associated with the payment, we believe an entity will generally apply View A (assuming any asset recorded is recoverable). If no revenue is expected as a result of the payment, View B may be appropriate.



## Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, the standard requires an entity to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services.

The standard requires an entity to first identify the specified good or service (or unit of accounting for the principal versus agent evaluation) to be provided to the customer in the contract in order to determine the nature of its promise. A specified good or service is defined in ASC 606-10-55-36 as each “distinct good or service (or distinct bundle of goods or services) to be provided to the customer.”

The second step in determining the nature of the entity’s promise (i.e., whether it is to provide the specified goods or services or to arrange for those goods or services to be provided by another party) is for the entity to determine whether the entity controls the specified good or service before it is transferred to the customer. An entity cannot provide the specified good or service to a customer (and therefore be a principal) unless it controls that good or service prior to its transfer. That is, as the Board noted in the Basis for Conclusions of ASU 2016-08,<sup>14</sup> control is the determining factor when assessing whether an entity is a principal or an agent.

Because it may not be clear whether an entity controls the specified good or service, the standard provides three indicators of when an entity controls the specified good or service and is therefore a principal. These indicators are meant to support an entity’s assessment of control, not to replace it, and each indicator explains how it supports the assessment of control. If an entity reaches different conclusions about whether it controls the specified good or service by applying the standard’s definition of control versus the principal indicators, the entity should reconsider its assessment considering the facts and circumstances of its contract. This is because the entity’s assessment of control and the principal indicators should align.

Retailers commonly enter into contracts with third parties (referred to as “vendors”) to provide goods or services to be sold through their sales channels to their customers. In these arrangements, the retailer may take legal title to the good only momentarily before the good is transferred to the customer, such as in a scan-based trading contract (e.g., vendor is responsible for stocking, rotating and otherwise managing the product until the final point of sale), or never takes physical possession or legal title to the good (e.g., when goods are shipped directly from a vendor to the customer). In these situations, the entity needs to carefully evaluate whether it obtains control of the specified good and therefore is the principal in the transaction with the end consumer. We believe some questions a retailer may consider when making this judgment could include:

- ▶ Does the entity take title to the goods at any point in the order-to-delivery process? If not, why?
- ▶ Is the vendor the party that the customer will hold responsible for the acceptability of the product (e.g., handling of complaints and returns)? If so, why?
- ▶ Does the entity have a return-to-vendor agreement with the vendor or have a history of returning goods to the vendor after a customer returns the good(s)? If so, why?

Retailers need to carefully evaluate whether a gross or net presentation is appropriate when third parties are involved in the sale of goods.

- ▶ Does the vendor have discretion in establishing the price for the goods (e.g., setting the floor or ceiling)? If so, why?
- ▶ Is the vendor responsible for the risk of loss or damage (e.g., shrinkage) while the goods are in the entity's store? If so, why?
- ▶ Does the vendor have the contractual right to take back the goods delivered to the entity and, if so, has the vendor exercised that right in situations other than when the goods were at the end of their useful lives?
- ▶ Can the entity move goods between their stores or relocate goods within their stores without first obtaining permission from the vendor? If not, why?
- ▶ Does the entity have any further obligation to the customer after remitting the customer's order to the vendor? If not, why?
- ▶ Once a customer order is placed, can the entity direct the product to another entity or prevent the product from being transferred to the customer? If not, why?

Understanding the business purpose and rationale for the contractual terms between the vendor and the entity may help the entity assess whether it controls the specified goods prior to the transfer to the end consumer and is therefore the principal in the sale to the end consumer.

### How we see it

Consistent with legacy GAAP, retailers need to carefully evaluate whether a gross or net presentation is appropriate when third parties are involved in the sale of goods through their sales channels to their customers.

While the standard includes guidance on principal versus agent considerations that is similar to legacy GAAP, the key difference is that ASC 606 focuses on control of the specified goods and services as the overarching principle for entities to consider when determining whether they are acting as a principal or an agent. That is, an entity first evaluates whether it controls the specified good or service before evaluating the indicators. This could result in entities reaching different conclusions than they did under legacy GAAP.

### Gift card breakage

Retailers frequently sell gift cards that may not be redeemed or completely redeemed. When an entity expects to be entitled to a breakage amount, it should recognize breakage as revenue in proportion to the pattern of rights exercised by the customer. In estimating any breakage amount, an entity has to consider the constraint on variable consideration. That is, if it is probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity should not recognize those amounts until the breakage amounts are no longer constrained. If an entity does not expect to be entitled to a breakage amount, it should not recognize any breakage amounts as revenue until the likelihood of the customer exercising its rights becomes remote.

Further, regardless of whether they can demonstrate the ability to reliably estimate breakage, entities should not estimate or recognize in income any amounts attributable to a customer's unexercised rights (e.g., an unused gift card balance) if the amounts are required to be remitted to another party (e.g., subject to escheat or unclaimed property laws that would require the amounts not used by customers to be remitted to a state or other taxing authority).

The guidance on breakage requires that an entity establish a liability for the full amount of the prepayment and recognize breakage on that liability as revenue proportionate to the pattern of rights exercised by the customer. If the prepayment element (e.g., the sale of a gift card, loyalty points) is one of multiple performance obligations identified in a contract, an allocation of the transaction price will need to be made between the identified performance obligations so the amount deferred as a contract liability may differ from the amount of prepayment received for the unsatisfied performance obligations. This is illustrated by Example 52 in the standard.<sup>15</sup>

### How we see it

Entities that applied a delayed recognition method to recognize breakage or did not estimate breakage under legacy GAAP have had to change practice under the standard.

## Selling-related goods or services

Many wholesale and consumer products entities provide goods and services to their customers (e.g., a reseller or retailer) to assist the customer in selling their product through to end consumers. These promises may be explicit (e.g., contractual) or implied by an entity's customary business practices. For example, entities may provide product displays or employees at the retailer's store to operate a brand-specific area or counter in the store. Under the standard, entities must identify the promised goods and services within the contract and determine which of those goods and services are separate performance obligations. Example 12 in the standard<sup>16</sup> illustrates how an entity should identify the promised goods and services in a contract (including both explicit and implicit promises).

The guidance in the standard permits an entity to disregard goods and services that are deemed to be immaterial in the context of a contract when it assesses whether promised goods or services are performance obligations. When evaluating whether a promised good or service is immaterial, an entity should consider the relative significance or importance of the good or service in the context of a contract as a whole. In doing so, entities need to consider both quantitative and qualitative factors, just as they do when considering materiality in other areas of US GAAP. If an entity determines that multiple goods or services are individually immaterial in the context of a contract, it will have to further assess the collective significance of those goods or services before concluding it is appropriate to consider them all immaterial in the context of the contract. This is because those individual immaterial items may be material in the aggregate to the contract.

The standard also contains guidance that requires entities to accrue for the costs of transferring immaterial goods or services to the customer in instances in which the costs will be incurred after the performance obligation (that includes those immaterial goods or services) has been satisfied. The FASB noted in the Basis for Conclusions of ASU 2016-10<sup>17</sup> that this requirement will more appropriately align the recognition of revenue and costs in the financial statements. The Board also observed that the cost accrual requirement in the standard only applies to items that are deemed to be promises to a customer in a contract. For example, an entity typically would not be required to accrue costs for operating a call desk to answer general inquiries about a product because doing that does not fulfill a promise to a customer.

### How we see it

Some "free" goods or services commonly considered marketing incentives or incidental goods or services under legacy GAAP have to be evaluated under the standard to determine whether they represent promised goods and services in a contract.

## Rights of return

Retail and consumer products entities typically provide customers with a right to return a transferred product. The right of return may be contractual, an implicit right that exists due to the entity's customary business practice or a combination of both (e.g., an entity has a stated return period but generally accepts returns over a longer period).

Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept a returned product. The standard states that such an obligation does not represent a performance obligation. Instead, the Board concluded<sup>18</sup> that an entity makes an uncertain number of sales when it provides goods with a return right. That is, until the right of return expires, the entity is not certain how many sales will fail. Therefore, the Board concluded that an entity should not recognize revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods. Instead, the potential for customer returns should be considered when an entity estimates the transaction price because potential returns are a component of variable consideration.

Entities recognize the amount of consideration received or receivable that is expected to be returned as a refund liability, representing their obligation to return the customer's consideration. Entities also recognize a return asset (and adjust cost of sales) for the right to recover the goods returned by the customer. They initially measure this asset at the former carrying amount of the inventory, less any expected costs to recover the goods, including potential decreases in value of the goods expected to be returned. At each reporting date, they remeasure the refund liability and update the measurement of the asset recorded for any revisions to the expected level of returns, as well as any additional decreases in the value of the products expected to be returned.

The standard requires the carrying value of the return asset to be presented separately from inventory and subject to impairment testing on its own, separately from inventory on hand. The standard also requires the refund liability to be presented separately from the corresponding asset (i.e., on a gross basis rather than a net basis).

"Like-kind exchanges" (i.e., exchanges by customers of one product for another of the same type, quality, condition and price) are not considered returns for the purposes of applying the standard. Generally, these exchanges are nonmonetary transactions within the scope of ASC 845, *Nonmonetary Transactions*. Further, the standard states that contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties included in the standard.

Example 22 in the standard<sup>19</sup> illustrates how to account for a right of return.

### How we see it

While the standard's accounting treatment for rights of return may not significantly change practice under legacy GAAP, there are some notable differences. The changes in this area (i.e., primarily treating the right of return as a type of variable consideration that must be accounted for using the variable consideration guidance, including the application of the constraint) may affect retail and consumer products entities. Entities have to assess whether their models for estimating returns are appropriate, given the need to consider the constraint and methods to estimate variable consideration (i.e., the expected value or the most likely amount method).

Separately presenting the right of return asset and refund liability on the balance sheet is also a change in practice from legacy GAAP for many retail and consumer products entities. Under legacy GAAP, the carrying value associated with any product expected to be returned typically remained in inventory and was not subject to separate impairment testing (although when the value of returned product was expected to be zero, inventory was fully expensed at the time of sale).

### Accounting for restocking fees

Some retail and consumer products entities charge customers a restocking fee when they return products to compensate them for various costs associated with the return, such as shipping and repacking costs. TRG members discussed<sup>20</sup> the accounting for such fees and generally agreed that restocking fees for goods expected to be returned should be included in the estimate of the transaction price at contract inception and recorded as revenue when (or as) control of the good transfers. This may be a change in practice for entities that recognized restocking fees when they received them under legacy GAAP.

### Private label and co-branded credit card arrangements (Updated July 2019)

Retailers often partner with financial institutions to issue credit cards. In a private label credit card arrangement, credit card holders can use their credit cards only for purchases of goods or services from the retailer. In another type of arrangement called a co-branded credit card arrangement, credit card holders can use their credit cards to purchase goods or services from the retailer or other merchants. These types of credit card arrangements are common in the retail industry and typically are used by retailers to promote consumer loyalty and increase sales.

In both arrangements, a retailer typically provides the financial institution a license to use the retailer's brand in marketing the credit card. Retailers may also provide other goods and services to the financial institution (e.g., access to the retailer's customer list or loyalty program points). A retailer may receive a variety of payments from the financial institution, including fixed up-front payments, royalties based on credit card purchases, a share of the profits and/or other payments for marketing activities.

A retailer may determine that both the credit card holder and the financial institution are customers of the retailer in the credit card arrangement. This may be the case if the retailer believes it is promising to transfer goods or services to both the credit card holder (i.e., retailer's goods or services) and the financial institution (e.g., providing access to the retailer's customer list and a license to use its brand).

### Identification of performance obligations

A retailer may promise different goods or services in contracts with a financial institution for private label and co-branded credit cards. Examples of goods or services that a retailer may promise to the financial institution include the following:

- License to use the retailer's intellectual property (IP) (e.g., trade names, trademarks)
- Access to the retailer's customer list
- Marketing-related activities
- Loyalty program points provided to credit card holders
- Other services (e.g., free shipping) provided to credit card holders

Accounting for credit card arrangements is complex and requires judgment.

A retailer must determine which of the promised goods and services in its contract with a financial institution to account for as separate performance obligations. In addition to providing a license to use the retailer's IP, a retailer may also provide access to its customer list. Access to the retailer's customer list and use of the retailer's brand generally would be combined into a single performance obligation if those individual promises are not separately identifiable. For example, if access to the retailer's customer list and the use of its brand significantly affect each other, the retailer may determine that these items should be accounted for as a single performance obligation. Similarly, in some cases, marketing activities may be combined with the license of the retailer's IP into a single performance obligation if those individual promises are not separately identifiable.

Because loyalty points can be accumulated and redeemed for free or discounted goods and services, a loyalty point a retailer provides to a credit card holder generally would represent a material right and should be accounted for as a separate performance obligation. For example, in a co-branded credit card arrangement where a retailer sells loyalty points to the financial institution at an agreed upon price per point, and the financial institution subsequently awards the points to its customers (i.e., credit card holders), the material right is a performance obligation in the contract with the financial institution. In other arrangements, the sale of points may not be a promise in the contract with the financial institution.

Once a retailer identifies the performance obligations in a credit card arrangement, it must determine the transaction price, allocate the transaction price to the performance obligations in proportion to their standalone selling prices and recognize revenue when (or as) each performance obligation is satisfied.

The standard generally requires an entity to estimate variable consideration (including consideration of the constraint) to determine the transaction price and allocate the transaction price using the relative standalone selling price method. However, there are some exceptions to the relative standalone selling price allocation method such as when the variable consideration is attributable to one or more, but not all, performance obligations in the contract and certain conditions are met. Because a retailer may identify more than one performance obligation in a credit card arrangement, it should consider whether any of the exceptions to allocating the transaction price using the relative standalone selling price method apply. In addition, if the contract consideration includes fixed up-front payments, the retailer should evaluate whether a significant financing component exists.

While this situation is not common, a retailer also may service financial assets (e.g., credit card receivables) for the financial institution. An asset servicer performs various activities such as communication with the borrower and payment collection. FASB TRG members discussed whether fees earned for servicing financial assets were in the scope of ASC 606. FASB TRG members generally agreed<sup>21</sup> that income from servicing financial assets is not in the scope of ASC 606 and that an entity should look to ASC 860, *Transfers and servicing*, to determine the appropriate accounting for servicing fees. This is because ASC 606 contains a scope exception for contracts that are in the scope of ASC 860, which provides guidance on the accounting for fees (despite not providing explicit guidance on revenue accounting).

If an element of the arrangement is covered by another ASC topic and that topic specifies how to separate and/or initially measure that element, the entity needs to apply ASC 606 to the remaining elements of the arrangement. ASC 860 provides initial measurement guidance for recognized servicing assets and liabilities and requires the recognition of a servicing asset or liability when the benefits of servicing obtained from the contract are greater than or less than adequate compensation (as defined), respectively, for performing the servicing.

## Licenses of IP

Because a credit card arrangement with a financial institution typically includes a license of IP, a retailer has to consider the licenses guidance when determining the nature of its overall promise to the customer and whether that promise is satisfied over time or at a point in time. A license to use an entity's brand is recognized over time because a brand does not have significant standalone functionality, and substantially all of its utility is derived from the entity's past or ongoing activities (including ordinary business activities to support its brand).

The consideration under the contract may include variable consideration that is based on credit card purchases, which could be a usage-based royalty. If the royalty relates only to the license of IP, the retailer recognizes royalties as revenue at the later of when the usage occurs or the performance obligation has been satisfied. If the royalty relates to more than the license of IP (e.g., if the contract contains the license of IP and other goods or services), the retailer should determine whether the license of IP is the predominant item in the contract to which the royalty relates.

For the license to be the predominant item, the retailer should have a reasonable expectation that the financial institution would ascribe significantly more value to the license than to the other goods or services in the contract (e.g., marketing services, ancillary services). If the license is determined to be predominant, the retailer recognizes the royalties as revenue at the later of when the usage occurs or the performance obligation has been satisfied (i.e., the royalty recognition constraint).

If a retailer determines that the license is not the predominant item to which the royalty relates, the retailer must estimate the transaction price (including consideration of the constraint) and determine the measure of progress that faithfully depicts its performance related to the license performance obligation. Appropriate methods to measure progress toward complete satisfaction of a performance obligation include output methods and input methods. When determining the appropriate method for measuring progress, an entity considers the nature of the good or service it promised to transfer to the customer.

Regardless of whether a retailer applies the royalty recognition constraint or the general constraint on variable consideration, it is still required to allocate sales- or usage-based royalties to separate performance obligations in the contract using the relative standalone selling price method, unless an exception applies.

### How we see it

Accounting for credit card arrangements is complex and requires judgment. Under ASC 606, the pattern of revenue recognition may differ from what a retailer recorded under legacy GAAP.

## Sales tax

Retailers often collect taxes from customers (e.g., sales tax) that they remit to the government. The standard includes a general principle that an entity should determine the transaction price, excluding amounts collected on behalf of third parties (e.g., some sales taxes). Constituents raised concerns that compliance with this aspect of the standard could be complex and costly for many entities because they would need to evaluate taxes they collect in each jurisdiction in which they operate to determine whether a tax is levied on the entity (and thus, the entity would include that amount in revenue and expenses) or the customer (and thus, the entity would exclude that amount from revenue and expenses because it is acting as a pass-through agent).

To alleviate these concerns, the standard<sup>22</sup> allows entities to make an accounting policy election to exclude sales taxes and other similar taxes from the measurement of the transaction price. The standard says the scope of the policy election includes “all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes)” but not taxes imposed on an entity’s gross receipts or the inventory procurement process. An entity that makes this election should comply with the disclosure requirements of ASC 235-10-50-1 through 50-6.

If an entity elects to exclude sales taxes and other similar taxes from the measurement of the transaction price, the entity would make that election for all sales taxes and other similar taxes in the scope of the policy election.

## Implicit price concessions

Consumer products entities may provide extended payment terms to their customers and will have to evaluate whether these terms represent an implied price concession because the entity does not intend to, or will not be able to, collect all amounts due in future periods.

The FASB acknowledged that in some cases, it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (i.e., impairment losses). The Board did not develop detailed guidance for distinguishing between price concessions (recognized as variable consideration through revenue) and impairment losses (recognized as bad debt expense outside of revenue). Therefore, entities should consider all relevant facts and circumstances when analyzing situations in which an entity is willing to accept a lower price than the amount stated in the contract.

### How we see it

The standard does not require entities to presume that extended payment terms lead to a transaction price that is not fixed or determinable, as they were required to do under legacy software revenue guidance. As a result, applying the standard could be less onerous for retail and consumer product entities that analogized to the legacy software revenue guidance, and it may accelerate the recognition of revenue for some of them.

## Shipping and handling

Many retail and consumer products entities perform shipping and handling activities to ship goods to customers. Under the standard, if the shipping and handling activities are performed before the customer obtains control of the good, then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity’s promise to transfer the good. If the shipping and handling activities occur after the customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good.

The accounting policy election should be applied consistently to similar types of transactions. The election is not required to be made at the entity level because the Board<sup>23</sup> recognized that some entities sell multiple classes of goods and contracts might vary significantly for different classes of goods. An entity that makes this election should comply with the disclosure requirements of ASC 235-10-50-1 through 50-6.

The standard also contains guidance that requires entities to accrue for fulfillment costs when they apply the policy election for shipping and handling activities. That is, entities are required to accrue for the costs of shipping and handling activities if revenue is recognized before contractually agreed shipping and handling activities occur.



Under the standard, an entity recognizes revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. While shipping terms may provide information about when legal title to a good transfers to the customer, they are not determinative when evaluating the point in time at which the customer obtains control of the promised asset. Retail and consumer products entities must consider all relevant facts and circumstances to determine whether control has transferred.

For example, when the shipping terms are free onboard (FOB) shipping point, entities should carefully consider whether the customer or the entity has the ability to control the goods during the shipment period. Furthermore, if the entity has the legal or constructive obligation to replace goods that are lost or damaged in transit, it should evaluate whether that obligation influences the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the goods. A selling entity's historical practices also should be considered when evaluating whether control of a good has transferred to a customer because the entity's practices may override the contractual terms of the arrangement.

If an entity considers shipping and handling activities to be a promised service to the customer, we believe the related costs should be classified as cost of sales because the costs would be incurred to fulfill a revenue obligation. We believe entities need to apply judgment to determine how to classify shipping and handling costs when the related activities are not considered a promised service to the customer (e.g., when an entity uses the accounting policy election to account for shipping and handling as a fulfillment activity). This is because the standard does not address how entities should classify these costs.

### How we see it

Under legacy guidance, entities did not recognize revenue if all of the significant risks and rewards of ownership had not transferred to the customer. For example, if the entity historically had agreed to repair or replace items lost or damaged in transit, even if the shipping terms were FOB shipping point, the delivery terms were generally accounted for as FOB destination point under legacy guidance. Under the standard, transferring risks and rewards of ownership is only one indicator of the timing of the transfer of control. As such, entities need to consider additional factors to determine when they transfer control of goods to the customer.

### Reseller/distributor arrangements

It is common for retail and consumer products entities to sell their products through distributors or resellers (collectively, resellers). When a retail or consumer products entity sells to a reseller, it needs to determine when it transfers control of the product to the reseller.

To help entities with this evaluation, the standard provides indicators of the transfer of control, which are summarized below:

- ▶ The entity has a present right to payment for the product sold to the reseller.
- ▶ The reseller has legal title to the product purchased.
- ▶ The reseller has physical possession of the product purchased.
- ▶ The reseller has the significant risks and rewards of ownership of the product purchased.
- ▶ The reseller has accepted the asset.

Transferring risks and rewards of ownership is only one indicator of when control transfers. Entities need to consider additional factors to determine when they transfer control of goods to the customer.

In many situations, the determination of when the reseller obtains control of the product is relatively straightforward. However, in other circumstances, this determination is more complex, such as when the entity retains legal title but has transferred the risks and rewards of ownership to the reseller.

Retail and consumer products entities sometimes have arrangements to deliver inventory on a consignment basis to resellers. By shipping on a consignment basis, consignors are able to better market products by moving them closer to the end user; however, they do so without selling the goods to the intermediary (consignee). Typically, a consignor will not relinquish control of the consigned product until the product is sold to the end consumer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the product other than to pay the consignor the agreed-upon portion of the sale price once the consignee sells the product to a third party. As a result, revenue generally would not be recognized for consignment arrangements when the products are delivered to the consignee because control has not transferred (i.e., the performance obligation to deliver goods to the end customer has not yet been satisfied).

The following illustration provides an example analysis of a distributor arrangement under the standard:

### **Illustration 3 – Sale of products to a distributor**

BCB Liquors (BCB) uses a distributor network to sell its product to end customers. Upon receipt of the product, a distributor receives legal title to the goods and is required to pay BCB for the product. In this example, BCB has determined its relationship with the distributor is not a consignment agreement.

BCB determines that its performance obligation for the sale of the product is satisfied at a point in time. BCB considers the indicators of transfer of control and concludes that control has transferred to the distributor when the product is delivered to the distributor. At this point in time, BCB has a present right to payment and the distributor has legal title and physical possession of the product as well as the risks and rewards of ownership. BCB concludes customer acceptance is a formality as BCB can objectively determine that the goods meet the agreed-upon specifications before shipment to the distributor.

Alternatively, if BCB sold the product to the distributor on consignment, the distributor was not obligated to pay for the product received until it was sold to the end customer and BCB had the ability to require the return of any unsold product or the distributor had an unlimited amount of time to return any unsold products, then BCB may have concluded that control of the product wouldn't transfer until it is sold to the end customer. Therefore, BCB would not recognize revenue until the product was sold to the end customer.

### **How we see it**

When they adopted ASC 606, many entities experienced significant changes in how they account for variable consideration. This was an even more significant change for entities that did not attempt to estimate variable consideration under legacy GAAP and simply recognized such amounts when cash was received or known with a high degree of certainty (e.g., upon receipt of a report from a customer detailing the amount of revenue due to the entity).

Because the sales price to the distributor or reseller may not be finalized until the product is sold to the end customer, many of these entities waited until the product was sold to the end customer to recognize revenue under legacy GAAP. The basis for this practice, known as the “sell-through” method, was that the sales price was not considered “fixed or determinable,” one of the general revenue recognition requirements of Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 13, until the product was sold to the end customer.

Under ASC 606, the practice of waiting until the product is sold to the end customer to recognize any revenue may no longer be acceptable if the only uncertainty is the variability in the pricing. This is because the standard requires an entity to estimate the variable consideration (i.e., the end sales price) based on information available, taking into consideration the effect on the constraint on variable consideration. However, in some cases, the outcomes under the standard and legacy methods could be similar if a significant portion of the estimated revenue is constrained.

## Licensing and franchise arrangements

Many retail and consumer products entities grant licenses of IP. Under such an arrangement, an entity typically receives royalties in exchange for a license to use certain IP (e.g., trademarks, trade names, copyrights) in connection with the operation of a retail store under a franchise arrangement or the manufacturing and sale of designated products. Entities are required to classify IP as either functional or symbolic. Refer to “Licenses of intellectual property” in the appendix to this publication for the definition of functional and symbolic IP.

### Sales- or usage-based royalties

Retail and consumer products entities commonly enter into arrangements that require the customer to pay a sales- or usage-based royalty in exchange for the license of IP. Sales- or usage-based royalties received in exchange for licenses of IP are recognized at the later of when (1) the subsequent sale or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (in whole or in part). That is, an entity recognizes the royalties as revenue when (or as) the customer’s subsequent sales or usage occurs, unless that recognition pattern accelerates revenue recognition ahead of the entity’s satisfaction of the performance obligation to which the royalty solely or partially relates based on an appropriate measure of progress.

#### *Estimating a sales- or usage-based royalty when there is a lag in reporting*

Entities have questioned whether they can recognize revenue for sales- or usage-based royalties for licenses of IP on a lag if actual sales or usage data is not available at the end of a reporting period. After the conditions in the royalty recognition constraint guidance have been met (i.e., the underlying sales or usage has occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied)), we believe that licensors without actual sales or usage data from the licensee will need to make an estimate of royalties earned in the current reporting period.

The SEC’s former Chief Accountant noted in a speech<sup>24</sup> that because the FASB did not provide “a lagged reporting exception” in the standard, the reporting of sales- and usage-based royalties may require estimation in some circumstances. This may result in a change in practice for entities that have previously recorded revenue from royalties on a lag (i.e., in a reporting period subsequent to when the underlying sales or usage occurs).

## How we see it

Having to estimate royalties earned in the current reporting period without actual sales or usage data from the licensee has been a significant change in practice for licensors that reported on a lag under legacy practice. Significant judgment is required to make these estimates. Licensors without this data need to implement processes and controls to collect data and develop assumptions to make a reasonable estimate.

The example below illustrates the accounting for a licensing arrangement with a sales-based royalty:

### Illustration 4 – Licensing

SSR Co. (SSR), a soft drink company, enters into a licensing contract with Fabrics Worldwide Inc. (FWI), an apparel company. The licensing contract permits FWI to use the SSR trademarked logo and tagline on a new line of FWI's T-shirts, hats, shorts and other apparel for a three-year period. As consideration, FWI pays SSR a one-time fee of \$1 million at the inception of the license term and an 11% sales-based royalty based on the total quarterly sales of apparel items that include the SSR logo. The rights and terms granted by SSR to FWI under the agreement are similar to those granted by SSR in licensing contracts with other apparel companies. FWI will provide updated sales data on a quarterly basis; however, this data will be available on a lag.

Assume that SSR determines that the nature of its promise is to provide FWI a right to access SSR's symbolic IP over time.

The up-front payment of \$1 million is recognized as the performance obligation (i.e., the license) is satisfied, which is over the three-year contract period. SSR would need to select a measure of progress that faithfully depicts its performance in providing FWI with access to its symbolic IP over the three-year contract period. The sales-based royalties are recognized when the underlying sales occur. Because the sales data is provided by FWI on a lag, SSR will make an estimate of royalties earned for each reporting period.

### Nonrefundable minimum guarantees for symbolic licenses

Retail and consumer products licensing arrangements commonly include a nonrefundable minimum guarantee that effectively establishes a floor for the amount of consideration to be paid to the licensor. The licensor earns additional sales-based royalties when the royalties exceed the nonrefundable minimum guarantee. Minimum guarantees may be negotiated for several reasons and may take different forms. For example, a contract might establish a minimum amount of consideration that is payable to the licensor in installments over the term of the license period, or the minimum amount of consideration could be paid at the beginning or end of the license period.

Contracts with a sales- or usage-based royalty and a minimum guarantee include both fixed and variable consideration. FASB TRG members generally agreed<sup>25</sup> that various recognition approaches could be acceptable for nonrefundable minimum guarantees promised in exchange for licenses of symbolic IP, which require revenue to be recognized over time. The TRG agenda paper describes two approaches. Under one, an entity would estimate the total consideration (i.e., the fixed minimum and the variable consideration from future royalties) and apply an appropriate measure of progress to recognize revenue as the entity satisfies the performance obligation, subject to the royalty recognition constraint. Alternatively, an entity could apply a measure of progress to the fixed consideration and begin recognizing the variable component when the fixed amount is exceeded on a cumulative basis.

The standard does not prescribe a single approach that must be applied in all circumstances in which a sales-based or usage-based royalty is promised in exchange for a license of IP and the contract includes a minimum guaranteed amount. An entity should consider the nature of its arrangements and make sure the measure of progress it selects does not override the core principle of the standard. An entity should disclose the accounting policy it selects because this would likely affect the amount and timing of revenue recognized.

### **Up-front fees in franchising arrangements**

Retail and consumer products entities may receive fees up-front upon the opening of a new franchise store and/or the granting of a new franchise term in addition to ongoing royalties based on a percentage of sales. Under the standard, entities must evaluate whether up-front fees relate to the transfer of a promised good or service. These entities should determine whether the nonrefundable up-front fees are compensation for one or more of the following:

- ▶ An initial service (i.e., a performance obligation) that is satisfied at the onset of the arrangement
- ▶ Promises that are not distinct from the performance obligations satisfied throughout the life of the franchise agreement
- ▶ Activities that they must undertake to fulfill a contract (e.g., administrative, setup activities) and that do not transfer a good or service to a customer

The standard requires that the up-front fees be included in the transaction price and allocated to the performance obligations in the contract. That is, treatment of the nonrefundable up-front fees should be no different from any other consideration received by the entity as part of the arrangement.

Example 57 in the standard<sup>26</sup> illustrates the accounting for a franchising arrangement with a nonrefundable up-front fee.

### **How we see it**

The legacy GAAP guidance regarding the accounting for franchise contracts has been superseded. If a franchising contract includes nonrefundable up-front fees, entities need to carefully evaluate whether those payments relate to a separate performance obligation distinct from the franchise license.

### **Warranty arrangements**

Retail and consumer products entities often sell products with warranties, which can be explicitly included in the contractual arrangement with a customer or may be required by law or regulation. In addition, an entity may have established an implicit policy of providing warranty services to maintain a desired level of satisfaction among its customers. Whether explicit or implicit, warranty obligations extend an entity's obligations beyond the transfer of control of the good or service to the customer, requiring it to stand ready to perform under the warranty over the life of the warranty obligation.

Entities may need to exercise significant judgment when determining whether a warranty is an assurance-type warranty (accounted for using a cost accrual approach) or a service-type warranty (accounted for as a performance obligation). An entity's evaluation may be affected by several factors, including common warranty practices within its industry and the entity's business practices related to warranties.

For example, a manufacturer of televisions may provide a three-year warranty on its high-end 4K HD televisions and a one-year warranty on its low-end televisions. The manufacturer may conclude that the longer warranty period on the high-end televisions is not an additional service because it believes the materials used to construct them are of higher quality, and latent defects would take longer to appear. In contrast, the manufacturer might consider the length of the warranty period and the nature of the services provided by the warranty and conclude the three-year warranty period, or some portion of it, is an additional service that should be accounted for as a service-type warranty.

Example 44 in the standard<sup>27</sup> illustrates the accounting for an assurance-type warranty.

### How we see it

Judgment may be required to determine whether a warranty is an assurance-type or service-type warranty. Retail and consumer products entities may find it challenging to estimate the standalone selling price of a service-type warranty when the warranty is not sold separately.

## Advertising costs, including direct-response advertising

Retail and consumer products entities may use direct-response advertising to generate sales from a customer (e.g., catalogs that include order coupons for an entity's products). Legacy guidance in ASC 340-20 allowed entities to capitalize the costs of direct-response advertising and certain tangible assets, such as blimps or billboards that may be used for several advertising campaigns, if certain criteria were met. That guidance in ASC 340-20 has been superseded by the standard.

Under the guidance in ASC 720-35, *Other Expenses – Advertising Costs*, the cost of advertising (excluding direct-response advertising and advertising costs capitalized under ASC 340-20) is expensed either as incurred or the first time the advertising takes place (e.g., advertisement is printed, broadcast, or posted on a website), depending on the accounting policy election the entity makes. An entity also accrues the costs of advertising when these costs are incurred after an entity recognizes revenue (e.g., in cooperative advertising arrangements).

### How we see it

Retail and consumer products entities typically are not able to capitalize direct-response advertising costs under the standard. Instead, these costs are typically expensed as incurred or the first time the advertising takes place.

## Consideration received from a vendor

Retailers may receive cash consideration from their vendors as sales incentives (e.g., slotting fees, rebates). Under ASC 705-20, *Cost of Sales and Services – Accounting for Consideration Received from a Vendor*, consideration received from a vendor is accounted for as a reduction of the purchase price of the goods acquired from the vendor unless the consideration is received for one of three things:

- ▶ In exchange for a distinct good or service transferred to the vendor
- ▶ A reimbursement of costs incurred to sell the vendor's products
- ▶ Consideration for sales incentives offered to customers by manufacturers

If the consideration from a vendor is in exchange for a distinct good or service that a retail entity transfers to the vendor, the retailer will account for the sale of the good or service in the same way that it accounts for other sales to customers in accordance with the standard. However, if the

amount of consideration from the vendor exceeds the standalone selling price of the distinct good or service that the retail entity transfers to the vendor, the retailer must account for such an excess as a reduction of the purchase price of any goods or services acquired from the vendor.

## How we see it

Under legacy guidance, the consideration received was presumed to be a reduction in the cost basis of the retailer's inventory and recognized in cost of sales once the products were transferred to the retailer's customer or milestones were achieved. However, the presumption could be overcome in certain circumstances. The new standard does not contain the same presumption. Under this guidance, if the consideration is in exchange for a distinct good or service, the standalone selling price must be estimated to determine whether the vendor is paying the retailer an excess amount that should be recorded as a reduction of the purchase price of the goods or services acquired from the vendor.

## Endnotes:

- <sup>1</sup> Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers, as amended, was created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, and various amendments.
- <sup>2</sup> ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*.
- <sup>3</sup> ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*
- <sup>4</sup> Paragraph BC386 of ASU 2014-09.
- <sup>5</sup> 31 October 2014 TRG meeting; agenda paper no. 6.
- <sup>6</sup> ASC 606-10-55-336 through 55-339.
- <sup>7</sup> ASC 606-10-55-353 through 55-356.
- <sup>8</sup> ASC 606-10-55-216 through 55-220.
- <sup>9</sup> In January 2016, the IASB announced that it did not plan to schedule further meetings of the IFRS constituents of the TRG but said it would monitor any discussions of the US GAAP group, which met in April and November 2016. The November 2016 meeting was the last scheduled FASB TRG meeting.
- <sup>10</sup> 18 April 2016 FASB TRG meeting; agenda paper no. 54.
- <sup>11</sup> Paragraph BC394 of ASU 2014-09.
- <sup>12</sup> 13 July 2015 TRG meeting; agenda paper no. 44.
- <sup>13</sup> 7 November 2016 TRG meeting; agenda paper no. 59.
- <sup>14</sup> Paragraph BC31 of ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*.
- <sup>15</sup> ASC 606-10-55-353 through 55-356.
- <sup>16</sup> ASC 606-10-55-151 through 55-157A.
- <sup>17</sup> Paragraph BC16 of ASU 2016-10.
- <sup>18</sup> Paragraph BC364 of ASU 2014-09.
- <sup>19</sup> ASC 606-10-55-202 through 55-207.
- <sup>20</sup> 13 July 2015 TRG meeting; agenda paper no. 35.
- <sup>21</sup> 18 April FASB TRG meeting; agenda paper no. 52.
- <sup>22</sup> ASC 606-10-32-2A.
- <sup>23</sup> Paragraph BC21 of ASU 2016-10.
- <sup>24</sup> Speech by Wesley R. Bricker, 9 June 2016. Refer to SEC website at <https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html>.
- <sup>25</sup> 7 November 2016 TRG meeting; agenda paper no. 58.
- <sup>26</sup> ASC 606-10-55-375 through 55-376.
- <sup>27</sup> ASC 606-10-55-309 through 55-315.

## Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer
<p><b>Definition of a contract</b></p> <p>An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:</p> <ul style="list-style-type: none"> <li>▶ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations</li> <li>▶ The entity can identify each party's rights regarding the goods or services to be transferred</li> <li>▶ The entity can identify the payment terms for the goods or services to be transferred</li> <li>▶ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract)</li> <li>▶ It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer</li> </ul> <p>If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.</p> <p><b>Contract combination</b></p> <p>The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:</p> <ul style="list-style-type: none"> <li>▶ The contracts are negotiated as a package with a single commercial objective</li> <li>▶ The amount of consideration to be paid in one contract depends on the price or performance of another contract</li> <li>▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation</li> </ul> <p><b>Contract modifications</b></p> <p>A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:</p> <ul style="list-style-type: none"> <li>▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract</li> <li>▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract</li> <li>▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services</li> </ul>



**Step 2: Identify the performance obligation(s) in the contract**

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- ▶ The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct)
- ▶ The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted
- ▶ One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

***Series guidance***

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

***Customer options for additional goods or services***

A customer's option to acquire additional goods or services (e.g., an option for free or discounted goods or services) is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

**Principal versus agent considerations**

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

- ▶ The entity is primarily responsible for fulfilling the promise to provide the specified good or service
- ▶ The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return)
- ▶ The entity has discretion in establishing the price for the specified good or service

**Step 3: Determine the transaction price**

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

**Variable consideration**

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

**Significant financing component**

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

**Noncash consideration**

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

**Consideration paid or payable to the customer**

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity or equity instruments granted in conjunction with selling goods or services. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

**Step 4: Allocate the transaction price to the performance obligations in the contract**

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer

The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

**Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation**

An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- ▶ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date

The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

### Licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of IP that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either:

- ▶ A right to access the entity's IP throughout the license period (a right to access)
- ▶ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use)

To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories:

- ▶ **Functional:** This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. However, we expect licenses of functional IP to meet the criteria to be recognized over time infrequently, if at all.
- ▶ **Symbolic:** This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP.

The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).

### Contract costs

ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. ASC 340-40 cites commissions as a type of incremental costs that may require capitalization. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future
- ▶ The costs are expected to be recovered

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment.