

Technical Line

FASB – final guidance

A closer look at the new revenue recognition standard – retail and consumer products

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What you need to know

- ▶ The new revenue recognition standard is more principles-based than current revenue guidance and will require retail and consumer products entities to exercise more judgment.
- ▶ The standard may affect retail and consumer product entities more than they think. For example, retail and consumer products entities may need to change the way they estimate returns and account for loyalty programs. They also may need to change how they present sales taxes.
- ▶ This publication expands on our earlier retail and consumer products industry Technical Line and discusses additional topics such as gift cards, warranties and up-front fees in franchising arrangements.
- ▶ The standard is effective for public entities for fiscal years beginning after 15 December 2016, including interim periods within those years, and for nonpublic entities in fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018.

Overview

Retail and consumer products entities may need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new standard will supersede virtually all existing revenue guidance under US GAAP and IFRS, including industry-specific guidance.



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The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements, such as the leasing literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate.

The standard may not significantly change the amount and timing of revenue that retail and consumer products entities recognize, but they will need to carefully evaluate all of their contracts to determine the effects of the standard and exercise more judgment when accounting for revenue than they do today. For example, retail and consumer products entities will need to use more judgment when accounting for loyalty programs, reseller arrangements, and licensing and franchising agreements. Further, aspects of the new standard that may cause changes for retail and consumer product entities include the requirements to report revenue net of sales taxes, consider the control principle when evaluating whether the entity is acting as a principal or an agent in a transaction, and record return assets on a gross basis separately from refund liabilities.

This publication provides an overview of the revenue recognition model and considers the standard's key implications for retail and consumer products entities. This publication expands on our earlier Technical Line, [The new revenue recognition standard – retail and consumer products](#) (SCORE No. BB2806). It also provides an overview of the revenue recognition model. This publication supplements our Technical Line, [A closer look at the new revenue recognition standard](#) (SCORE No. BB2771), and should be read in conjunction with it.

Retail and consumer product entities also may want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG). The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. Separately, the American Institute of Certified Public Accountants (AICPA) has established 16 industry task forces to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. The AICPA has not established a task force for the retail or consumer product industries. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our guidance.

Scope, transition and effective date

The scope of the new revenue recognition guidance includes all contracts with customers to provide goods or services in the ordinary course of business, except for contracts that are specifically excluded from the scope (e.g., leases, insurance contracts, financial instruments, guarantees). Also excluded from the scope of the guidance are nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange.

The new standard is effective for public entities¹ for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017, and interim periods within fiscal years beginning after 15 December 2018. Nonpublic entities may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach. A Securities and Exchange Commission (SEC) staff member also said recently that the staff won't object if registrants that use the full retrospective approach do not recast the earliest two years in their five-year selected financial data disclosures.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures during the year of adoption, such as the amount by which each financial statement line item is affected as a result of applying the new standard.

Summary of the new model

The new guidance outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize 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.

The principles in the standard are applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

Retail and consumer product entities will need to exercise judgment when considering the terms of their contracts and all the facts and circumstances. They will need to consider all contracts that are legally enforceable, including implied and oral contracts. Entities also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity will have to provide more disclosures than it does today and include qualitative and quantitative information about its contracts with customers, significant judgments it made (and changes in those judgments) and capitalized costs from costs to obtain or fulfill a contract. US GAAP will require more disclosures in interim periods than IFRS.

Identify the contract with the customer

The model applies to each contract with a customer. Contracts may be written, oral or implied by an entity's customary business practices but must be enforceable by law and meet specified criteria. One of the criteria is that an entity must conclude it is probable that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. The amount of consideration to which an entity will be entitled (i.e., the transaction price) may differ from the stated contract price (e.g., if the entity intends to offer a concession and accept an amount less than the contractual amount). When performing the collectibility assessment, an entity should consider only the customer's ability and intention to pay the expected consideration when due.

This step of the model also includes guidance on accounting for contract modifications. A contract modification is a change in the scope or price (or both) of a contract. An entity must determine whether the modification should be accounted for as a separate contract or as part of the original contract. Two criteria must be met for a modification to be considered a separate contract: (1) the additional goods or services are distinct from the goods or services in the original contract, and (2) the consideration expected for the added goods or services reflects the standalone selling prices of those items.

A contract modification that does not meet the criteria to be accounted for as a separate contract is considered a change to the original contract. It is treated as either the termination of the original contract and the creation of a new contract or as a continuation of the original contract, depending on whether the remaining goods or services to be provided after the contract modification are distinct.

How we see it

For retail and consumer products entities, the identification of the contract with a customer under the new model will be similar to how it is done today, but entities will need to evaluate the legal enforceability of all their contracts and their collectibility. A contract generally exists at the point of sale, when the goods or services are delivered or when a sales agreement is executed.

Retail and consumer products entities that enter into other contracts, such as franchise or licensing arrangements, will need to evaluate the terms of each contract to see whether or when the criteria in the new standard are met.

Properly identifying performance obligations within a contract will be critical.

Identify the performance obligations in the contract

After identifying the contract, an entity will evaluate the contract terms and its customary business practices to identify all promised goods or services within the contract and determine which of those promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations.

Promised goods and services represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods and services) or if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer. A good or service (or bundle of goods and services) is distinct if (1) the customer can benefit from the good or service on its own or together with other readily available resources (i.e., the good or service is capable of being distinct), and (2) the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

In many cases, identifying the performance obligations within the contract will be straightforward for retail and consumer products entities, such as in a point-of-sale transaction or the sale of a manufactured good. In other cases, it may be more complex. For example, a contract may include an option for additional goods or services (e.g., a contract renewal) or a license for intellectual property (e.g., a trademark). When a reseller is involved, entities also will need to consider whether they are acting as the principal or agent in the transaction. These complexities are discussed below.

The Boards had considered providing entities with relief from accounting for performance obligations that the entity considers to be inconsequential or perfunctory. The Boards decided not to provide such relief because all goods or services promised to a customer as a result of a contract give rise to performance obligations. The Boards determined that those promises were made as part of the negotiated transaction between the entity and its customer, and the entity should allocate consideration to them for purposes of revenue recognition.

Customer options for goods or services

Retail and consumer products entities frequently give customers the option to purchase additional goods or services. These options come in many forms, including sales incentives (e.g., coupons with a limited distribution, competitor price matching programs aimed at only some customers, gift cards issued by a retailer as a promotion), customer award credits (e.g., loyalty or reward programs), contract renewal options (e.g., waiver of certain fees, reduced future rates) or other discounts on future goods or services.

The standard states that when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right 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). While the Boards did not provide any bright lines about what constitutes a “material” right, they indicated in the Basis for Conclusions that the purpose of this guidance is to identify and account for options that customers are essentially paying for (often implicitly) as part of the transaction. If the discounted price offered in the option reflects the standalone selling price (separate from any existing relationship or contract), the entity is deemed to have made a marketing offer rather than having granted a material right. The standard states that this is the case even if the option can be exercised only because the customer entered into the earlier transaction.

The assessment of whether the entity has granted its customer a material right could require significant judgment. Retail and consumer product entities frequently offer discounts on future purchases to customers who spend a specified amount through a loyalty program or voucher incentive. For example, an entity may give customers who spend \$100 or more during a specified period a \$15 discount on a future purchase, and the discount may be in the form of a coupon/voucher or gift card to be used within two weeks from the sale date. An entity will have to determine whether this offer represents a material right and, if so, allocate a portion of the transaction price to it on a relative standalone selling price basis. Further, in determining the standalone selling price of the coupon/voucher or gift card, it is unclear whether the substance of a transaction or the legal form would prevail. That is, an entity likely would have an observable standalone selling price for gift cards, which could be different from an estimated standalone selling price for a coupon or voucher of equal value because, for example, the estimate would likely include estimates of breakage.

The standard provides the following example to illustrate how retail and consumer products entities may determine whether an option represents a material right:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers – Overall

Implementation Guidance and Illustrations

Example 49–Option That Provides the Customer with a Material Right (Discount Voucher)

606-10-55-336

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 percent discount voucher for any future purchases up to \$100 in the next 30 days. The entity intends to offer a 10 percent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 percent discount cannot be used in addition to the 40 percent discount voucher.

606-10-55-337

Because all customers will receive a 10 percent 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 percent (that is, the additional 30 percent 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.

606-10-55-338

To estimate the standalone selling price of the discount voucher in accordance with paragraph 606-10-55-44, the entity estimates an 80 percent 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 percent incremental discount × 80 percent 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	<u>12</u>
Total	<u>\$ 112</u>
Performance obligation	Allocated transaction price
Product A	\$ 89 (\$100 ÷ \$112 × \$100)
Discount voucher	<u>11</u> (\$12 ÷ \$112 × \$100)
Total	<u>\$ 100</u>

606-10-55-339

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

How we see it

The accounting under the new standard may be more complex for retail and consumer product entities that grant options to customers to purchase additional goods or services. Entities will need to use significant judgment to determine which options provide material rights to the customers. Entities that provide material rights to customers will need processes and systems to estimate the standalone selling price and allocate the transaction price to the current and future purchases based on that estimate.

Customer loyalty programs

The new standard may change how retail and consumer product entities account for loyalty or reward programs. When a retail or consumer products entity determines that a loyalty or reward program creates a performance obligation (because it provides a material right to the customer), it will allocate a portion of the transaction price to the loyalty program and recognize revenue when the performance obligation is satisfied (e.g., when the loyalty points are

redeemed or expire, applying the breakage concepts discussed below). Example 52 in the standard (Accounting Standards Codification (ASC) 606-10-55-353 through 55-356) illustrates the accounting for a customer loyalty program in a retail or consumer product arrangement.

Today, retail and consumer product entities analogize to the guidance in either ASC 605-50, *Customer Payments and Incentives*, or ASC 605-25, *Multiple-Element Arrangements*, when accounting for point and loyalty programs. Entities that analogize to ASC 605-50 accrue the estimated costs of providing free or discounted goods or services to the consumers that are expected to redeem accumulated award credits (referred to as the incremental cost method). Entities that analogize to ASC 605-25 account for award credits as a revenue element included in a multiple-element arrangement (i.e., as a current sale of a product or service and an obligation to deliver future products or render future services). The revenue allocated to the award credits is deferred until the award credits are redeemed, expire or when it is remote that any unused award credits will be redeemed (depending on the entity's accounting policy for breakage).

How we see it

Retail and consumer products entities that currently apply the incremental cost method will have to change how they recognize loyalty or reward programs if such programs provide a material right to their customers. They will need to apply significant judgment to estimate the standalone selling price of the award credits. This likely will require changes to an entity's accounting policies, accounting systems and/or internal control over financial reporting.

Principal versus agent considerations

Retailers typically enter into contracts with third parties to provide goods or services to be sold through their sales channels to their customers. Under the new standard, when other parties are involved in providing goods or services to an entity's customer, the entity must determine whether its performance obligation is to provide the good or service itself (i.e., the entity is a principal) or to arrange for another party to provide the good or service (i.e., the entity is an agent). The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognizes. That is, when the entity is the principal in the contract, the revenue recognized is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognized is the net amount the entity is entitled in return for its services as the agent. The entity's fee or commission may be the net amount of the consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

A principal's performance obligations in a contract differ from an agent's performance obligations. For example, if an entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity's performance obligation may be to provide the goods or services itself. Hence, the entity likely is acting as a principal and should recognize revenue in the gross amount to which it is entitled. An entity that obtains legal title of a product only momentarily before legal title is transferred to the customer is not necessarily acting as a principal. In contrast, if an agent facilitates the sale of goods or services to the customer in exchange for a fee or commission and generally does not control the goods or services for any length of time, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer.

Because it can be sometimes challenging to identify the principal in a contract, the standard provides indicators to help an entity make this determination. While these indicators are based on indicators included in today's guidance, they have a different purpose because they

are based on the concepts of identifying performance obligations and the transfer of control of goods or services. Appropriately identifying the entity's performance obligation in a contract is fundamental in determining whether the entity is acting as an agent or a principal.

How we see it

Consistent with current practice, entities will need to carefully evaluate whether a gross or net presentation of revenue is appropriate under the new standard. While the guidance in the standard is similar to today's guidance, there are some notable differences.

For example, the standard says entities need to consider whether they have control of the goods and services, which adds an overarching principle to the indicators. The standard also eliminates today's requirement to weight certain indicators more heavily than others. As a result, entities will be able to assess the importance of the indicators based on their facts and circumstances. Further, the indicators serve a different purpose under the new standard. As a result, entities in similar circumstances may reach different conclusions.

Retailers will have to carefully consider the effect on their principal-agent analysis when they control goods only momentarily (i.e., when they have flash title) before selling goods to an end customer. This may occur when the retailer operates a store within a store or has an agreement in which the vendor is responsible for stocking, rotating and otherwise managing the product until the final point of sale (e.g., some greeting card arrangements).

Entities will need to carefully evaluate whether to present revenue on a gross or net basis.

At its first meeting in July, the TRG discussed a number of principal-agent issues, including how to apply the indicators to the sale of intangible goods or services (e.g., vouchers for events or travel services, electronic gift cards) and whether certain items billed to customers (e.g., shipping and handling, reimbursement of out-of-pocket expenses, taxes, other assessments) should be presented as revenue or as a reduction of costs. The Boards have asked their staffs to research whether there are specific improvements they could make to help entities make judgments in the principal versus agent assessment for arrangements involving certain intangible goods or services. The TRG will meet again on 31 October 2014.

Determine the transaction price

The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties (e.g., some sales taxes). This may be a significant change in practice because under today's guidance, entities can elect to include sales taxes in revenue (on a gross basis).

Under the new standard, entities will need to evaluate all taxes collected in all jurisdictions where they operate to determine whether a tax is levied on the entity or whether the entity is collecting the amount on behalf of its customer (i.e., as an agent for a government or other taxing authority). While sales taxes may be the most common type of consideration collected by retail and consumer products entities on behalf of third parties, an entity will need to carefully consider other amounts that may be collected (e.g., certain tariffs on the cross-border movement of goods that may be imposed on the seller) to determine the appropriate accounting.

When determining the transaction price, an entity should consider the effects of all of the following: (1) variable consideration, (2) a significant financing component (i.e., the time value of money), (3) noncash consideration and (4) consideration payable to a customer.

Prices for goods sold to customers by retail and consumer products entities are typically established or stated (e.g., manufacturer's suggested retail price, list price). However, it is customary in the retail and consumer products industries to provide return rights and price

concessions, which are items that cause consideration to be variable under the new standard. In addition, consideration payable to a customer is common within both industries. Each of these items may make determining the transaction price more challenging.

Variable consideration

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. Consideration also can vary if it's contingent on the occurrence or nonoccurrence of a future event (e.g., right of return, achievement of a milestone). Under the new standard, variable consideration must be estimated using either the "expected value" method or the "most likely amount" method, based on which approach better predicts the amount of consideration to which the entity is entitled. The entity should apply the selected method consistently throughout the contract and for similar types of contracts.

The standard limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. That is, the standard requires an entity to apply a constraint on variable consideration. This determination includes considering both the likelihood and magnitude of a revenue reversal. The estimate of variable consideration, including the amounts subject to constraint, is updated at each reporting period.

The standard provides the example below to show how retail and consumer products entities may account for variable consideration related to volume discounts.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers – Overall

Implementation Guidance and Illustrations

Example 24 – Volume Discount Incentive

606-10-55-216

An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for \$100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to \$90 per unit. Consequently, the consideration in the contract is variable.

606-10-55-217

For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

606-10-55-218

The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of \$7,500 (75 units × \$100 per unit) for the quarter ended March 31, 20X8.

606-10-55-219

In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to \$90.

606-10-55-220

Consequently, the entity recognizes revenue of \$44,250 for the quarter ended June 30, 20X8. That amount is calculated from \$45,000 for the sale of 500 units (500 units × \$90 per unit) less the change in transaction price of \$750 (75 units × \$10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

How we see it

We anticipate that entities may find it challenging to apply the constraint on variable consideration, especially determining when it is probable that a significant revenue reversal will not occur. Retail and consumer products entities will need to apply judgment and evaluate their specific facts and circumstances when implementing this aspect of the standard. Over time, best practices may emerge, and implementation guidance may be developed to help entities apply the constraint.

Rights of return

Retail and consumer product entities typically provide rights of return to customers. The rights of return may be contractual, implicit due to 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). The Boards decided that standing ready to accept a returned product does not represent a performance obligation in a contract. Instead, they determined that the potential for customer returns should be considered when an entity estimates the transaction price because potential returns are a component of variable consideration.

Consistent with current practice, the Boards determined that "like-kind exchanges," which are exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one color or size for another), are not considered returns for the purposes of applying the new standard. Generally, these exchanges would be nonmonetary transactions within the scope of ASC 845, *Nonmonetary Transactions*.

Under the new standard, an entity will estimate the transaction price and apply the constraint to that estimate. In doing so, it will consider the products expected to be returned to determine the amount to which it expects to be entitled (excluding the products expected to be returned). Retail and consumer products entities may find that the amount of estimated returns under the new standard is generally consistent with amounts estimated today. However, entities may need to adjust their processes or update their documentation to appropriately apply the new guidance (e.g., an entity may need to adjust its calculation of expected returns to use an "expected value" or "most likely amount" method instead of calculating an amount based on historical returns).

Entities will recognize the amount of expected returns as a refund liability, representing their obligation to return the customer's consideration. Entities will also recognize a return asset (and adjust cost of sales) for the right to recover the goods returned by the customer. They will initially measure this asset at the former carrying amount of the inventory, less any

expected costs to recover the goods. At each reporting date, they will 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 potential decreases in the value of the returned products. That is, a returned item should be recognized at the lower of the original cost, less the cost to recover the asset, or the fair value of the asset at the time of recovery.

The balance sheet classification for amounts related to assets subject to the right of return may be a change from current practice. Under today's guidance, the carrying value associated with any products expected to be returned typically remains in inventory. The new guidance requires the asset to be recorded separately from inventory to provide greater transparency. It also requires the carrying value of the return asset (i.e., the product expected to be returned) to be subject to impairment testing on its own, separately from inventory on hand.

The new standard also requires the refund liability to be presented separately from the corresponding asset (on a gross basis rather than a net basis). The return asset and refund liability are also subject to additional disclosure requirements.

Example 22 in the standard (ASC 606-10-55-202 through 55-207) illustrates how to account for a right of return.

How we see it

Entities will have to assess whether their current models for estimating returns are appropriate given the required methods for estimating the transaction price (i.e., the expected value or the most likely amount method) and the requirement to apply the constraint on variable consideration. While the method for estimating expected returns will change, the outcome may remain the same.

Price concessions and extended payment terms

Consumer products entities often offer price concessions to their customers. Today, entities generally estimate the amount of price concessions to be offered based on past history and record it as a reduction of revenue. Under the new standard, an entity's intention or willingness at the outset of the arrangement to offer a price concession is considered a form of variable consideration and, as such, must be taken into consideration when estimating the transaction price.

If an entity has an established practice of providing price concessions, or the entity enters into a contract with the expectation of collecting less than the stated contractual amount, such actions may represent implied or granted concessions that should be reflected in the transaction price rather than as bad debt expense. Example 23 in the standard (ASC 606-10-55-208 through 55-209) illustrates the accounting for a price concession.

Consumer product entities also may provide extended payment terms to their customers. An entity will need to carefully evaluate contracts that include such terms to determine whether the entity has an intention, or a valid expectation, that it will provide a price concession over the financing term. Under the new standard, when a contract provides the customer with extended payment terms, an entity will need to consider whether those terms create variability in the transaction price and whether a significant financing component exists.

For example, a consumer product entity may have a business practice of providing price concessions in contracts that include extended payment terms in order to negotiate a contract renewal with customers. Such price concessions are a form of variable consideration, which are required to be estimated at contract inception and deducted from the transaction price.

The treatment of extended payment terms under the new standard may represent a significant change from current practice. SEC Staff Accounting Bulletin (SAB) Topic 13 notes that entities should consider the guidance on extended payment terms in ASC 985-605, *Software – Revenue Recognition*, even if the arrangement is not subject to the scope of that standard. ASC 985-605 has restrictive criteria for the recognition of revenue that is not certain, including a presumption that extended payment terms lead to a transaction price that is not fixed or determinable because of an increased risk of the entity granting future price concessions to its customer. As a result, under today's guidance, an entity may be restricted from recognizing revenue for arrangements that include extended payment terms, unless it can determine that including such terms does not prevent the transaction from meeting the general revenue recognition criteria in SAB Topic 13.

Although the new guidance differs in approach from today's guidance, it has a relatively high threshold (in the form of the constraint on variable consideration) that must be met before an entity can include amounts in the transaction price that can be recognized as revenue. However, entities that expect to be entitled to some portion of the consideration due under a contract may be able to recognize revenue earlier than they do today, despite the extended payment terms, if they determine that portion of the transaction price is not constrained.

Consideration paid or payable to a customer

Many consumer products entities make payments to their customers. Common examples of consideration paid to a customer include (1) slotting fees, (2) cooperative advertising arrangements, (3) buy downs or price protection, (4) coupons and rebates, (5) "pay to play" arrangements, and (6) the purchase of goods or services. In addition, some entities 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). Further, the promise to pay the consideration might be implied by the entity's customary business practice.

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. In order for an entity to treat its payment to a customer as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct, as discussed above.

If the consideration paid or payable to a customer is a discount or refund for goods or services provided to a customer, 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 the entity promises to pay the consideration, taking into consideration the entity's customary business practices (i.e., the promise could be implied). This is true even when the payment is contingent on a future event.

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 the sale of such a product to a retailer.

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 an "expected value" method or a "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 estimate of the discount or refund. The entity must choose the estimation approach that it believes best predicts the revenue to which it expects to be entitled.

The standard includes this example of consideration paid to a customer.

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers – Overall

Implementation Guidance and Illustrations

Example 32 – Consideration Payable to a Customer

606-10-55-252

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least \$15 million of products during the year. The contract also requires the entity to make a nonrefundable payment of \$1.5 million to the customer at the inception of the contract. The \$1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

606-10-55-253

The entity considers the guidance in paragraphs 606-10-32-25 through 32-27 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 606-10-32-25, the \$1.5 million payment is a reduction of the transaction price.

606-10-55-254

The entity applies the guidance in paragraph 606-10-32-27 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognizes revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 percent ($\$1.5 \text{ million} \div \15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognizes revenue of \$1.8 million ($\$2.0 \text{ million invoiced amount} - \$0.2 \text{ million of consideration payable to the customer}$).

The guidance on when consideration payable to a customer should be recognized appears to be inconsistent with the requirements to consider implied price concessions as variable consideration. That is, the standard's definition of variable consideration is broad enough to include amounts such as coupons or other forms of credits that can be applied to the amounts owed. That guidance requires that all potential variable consideration be considered and reflected in the transaction price at inception and 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 suggests that such amounts should be considered at the inception of the arrangement, even if the entity hasn't yet offered this consideration to the customer.

How we see it

Because consideration paid to a customer can take many forms, entities will have to carefully evaluate each transaction or type of transaction to determine the appropriate treatment of such amounts. Entities will also have to determine whether to incorporate consideration paid/payable to a customer in the transaction price at contract inception or at a later date.

The new guidance on accounting for consideration payable to a customer is generally consistent with today's guidance. However, the determination of whether a good or service is "distinct" may differ from today's requirement to determine whether the vendor has received an "identifiable benefit" from the customer in order to treat the consideration payable to a customer as anything other than a reduction of revenue.

Further, it's unclear whether the Boards intend for the guidance on consideration paid to a customer to be applied as broadly as it is today. Today's guidance requires entirely separate transactions to be considered when applying the guidance. For example, if an entity makes contributions to a charitable organization that is also the entity's customer, the contributions are likely within the scope of today's guidance. The new guidance has similar language but not the exact words that are in today's guidance. Also, in the Basis for Conclusions, the Boards note that the amount of consideration received from a customer for goods or services, and the amount of any consideration paid to that customer for goods or services, could be linked even if they are separate events. However, how entities will apply the guidance under the new standard has not yet been determined.

Allocate the transaction price to the performance obligations

Once the performance obligations have been identified and the transaction price has been determined, an entity will allocate the transaction price to the performance obligations generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis), with limited exceptions. An entity will need to allocate variable consideration to one or more, but not all, performance obligations in some situations. The standard also contemplates the allocation of any discount in a contract to one or more, but not all, performance obligations, if specified criteria are met. The transaction price is not reallocated to reflect changes in standalone selling prices after contract inception.

When determining standalone selling prices, an entity must use observable information, if available. If standalone selling prices are not directly observable, an entity will need to make estimates based on information that is reasonably available using, for example, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach. Entities should apply the method they use consistently in similar circumstances.

How we see it

The guidance on estimating a standalone selling price is largely consistent with today's guidance in ASC 605-25, and standalone selling prices for goods sold by retail and consumer products entities are often directly observable because many of the goods are regularly sold on a standalone basis.

Satisfaction of performance obligations

An entity recognizes revenue only when it satisfies a performance obligation by transferring control of a promised good or service to the 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 for being 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.

When a performance obligation is satisfied over time, the standard requires an entity to select a single method (either an input method or an output method) to measure progress for each performance obligation that best depicts the entity's performance in transferring the good or service.

For most retail and consumer products entities, revenue generally will be recognized at a point in time when the product is delivered (i.e., at the point in time when control is transferred to the customer). These entities also may provide services, for which revenue would be recognized when (or as) the service is performed.

Reseller and distributor arrangements

The standard could change practice for entities that sell their products through distributors or resellers (collectively, resellers). It is common in the retail and consumer product industries for entities to provide resellers with greater rights than end customers to maintain a mutually beneficial relationship and maximize future sales opportunities through the reseller. For example, an entity may provide a reseller with price protection and extended return rights.

Entities will need to evaluate when control of the product transfers to the customer. To do this, entities may need to first assess whether their contracts with resellers are consignment arrangements. Retail and consumer products entities frequently deliver inventory on a consignment basis to other parties (e.g., reseller, retailer). Shipping on a consignment basis helps consignors market the products better by moving them closer to the end customer; however, they do so without selling the goods to the intermediary (consignee).

In the retail industry, consignment arrangements are typically described as scan-based trading. The vendor's goods are showcased on a retailer's sales floor or website, but the vendor retains title of the goods until the product is sold to the end customer (i.e., the point of sale). At that point, the retailer has an obligation to pay the vendor for the goods sold, and the vendor recognizes revenue.

Entities entering into a consignment arrangement must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the inventory to the consignee or to transfer the inventory to the end customer). Under the new standard, this determination should be based on whether control of the inventory has passed to the consignee upon delivery. Typically, a consignor will not relinquish control of consignment inventory until the inventory is sold to the end customer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the inventory other than to pay the consignor the agreed-upon portion of the sale price once the consignee sells the product to the end customer.

As a result, revenue generally would not be recognized for consignment arrangements when the goods 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 entity would wait until the reseller sells the product to an end customer to recognize revenue, which would be considered the point in time that the entity has transferred control of the product. The result would be similar to today's practice of deferring revenue recognition until the reseller sells the product to an end customer (i.e., the sell-through method).

If an entity concludes that its contract with a reseller is not a consignment arrangement, the reseller likely will be considered a customer of the entity. The entity would be required to recognize revenue upon the transfer of control of the promised goods in the amount to which

The new standard could change practice for entities that sell their products through distributors or resellers.

the entity expects to be entitled. Today, many entities wait until the product is sold to the end customer to recognize revenue because they do not meet all of the criteria in SAB Topic 13 to recognize revenue when they deliver the product to the reseller. For example, if an entity cannot reasonably estimate the future price changes resulting from price protection to be provided to the reseller, the fee would not be considered fixed or determinable, and deferral of revenue would be required until the reseller sells the product to an end customer.

In determining the amount to which they expect to be entitled, entities will be required to consider whether they will provide resellers with explicit or implicit concessions (e.g., price protection, expanded return rights, stock rotation rights) that will make the transaction price variable. In these instances, an entity will need to estimate the transaction price and, after applying the constraint, include only the amount for which the entity determines it is probable that a significant reversal will not occur. An entity will need to carefully consider whether it can include the variable consideration resulting from the concessions it offers to its reseller customer(s) in its transaction price. The standard indicates that an entity that has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances is a factor that could increase the likelihood (or magnitude) of a revenue reversal. Entities will need to carefully assess the facts and circumstances of their contracts to determine whether their accounting will change under the new standard.

The example below illustrates a consumer product entity's accounting for products sold through a distributor network.

Illustration 1 – Sale of products to a distributor

BCB Liquors (BCB) uses a distributor network to supply its product to end customers. Upon receipt of the product, the distributor receives legal title of the goods and is required to pay BCB for the product. Under their agreements with BCB, the distributors may return unsold product within 90 days. Once the distributors sell the products to the end customer, BCB has no further obligations for the product, and the distributors have no further return rights.

In this example, BCB has determined its relationship with the distributors is not a consignment agreement. That is, because the distributor has legal title to the product without any restrictions, an obligation to pay for the product when received and BCB cannot make distributors return the product, BCB determines that control has transferred to the distributor when the product is delivered. In addition, because BCB offers a right of return to the distributor, BCB would be required to estimate the transaction price (considering expected returns) and record a liability for the amount of returns expected during the 90-day return period.

Alternatively, if the distributors were not obligated to pay for the product received until it was sold to the end customer and the distributor has the option to return any unsold products, BCB may have concluded that control of the products doesn't transfer until they are sold to the end customer; therefore, the contracts with the distributor are consignment arrangements.

Gift card breakage

Retailers frequently sell gift cards that may not be redeemed or completely redeemed, and the unused amount (i.e., the amount attributable to a customer's unexercised rights to future goods or services) is often referred to as breakage. The Boards concluded that when an entity expects to be entitled to a breakage amount, it should recognize the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Because breakage

amounts essentially represent a form of variable consideration, when 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 will occur for any estimated breakage amounts, an entity should not recognize those amounts until it is probable that a significant revenue reversal will not occur.

If an entity cannot determine whether breakage will occur, it should not recognize any amounts as breakage until the likelihood of the customer exercising its rights becomes remote. This may be the case when an entity first begins to sell gift cards and has no history of breakage patterns.

Further, regardless of whether a retailer can demonstrate the ability to reliably estimate breakage, no such amounts should be estimated and recognized in income if the unused balances of gift cards are subject to the escheat or unclaimed property laws of states or other taxing authorities or jurisdictions.

The example below illustrates a contract with a single performance obligation (i.e., the sale of a gift card to a customer).

Illustration 2 – Gift card

Good Toys Ltd. (GTL), a toy store, sells a \$75 gift card to a customer. GTL's gift cards have no fees or expiration dates. For purposes of this example, assume no state or other jurisdictional escheatment laws apply.

GTL has sold gift cards for a number of years and has reliable historical evidence of breakage. Using an expected value approach, it estimates that 4% of gift card balances will not be redeemed by the customer. GTL evaluates the constraint on variable consideration and determines it is probable that a significant revenue reversal will not occur for the 4% estimated breakage amount.

At the point of sale of the gift card to the customer, GTL would record a contract liability of \$75. One week later, the customer returns to the store and uses the gift card to purchase \$48 worth of goods. GTL recognizes \$48 of revenue at that time, with a corresponding decrease to the contract liability. In addition, GTL recognizes estimated breakage revenue, with an offset to the contract liability, of \$2 at the time of redemption, calculated as follows:

$$(4\% \times \$75) = \$3 \text{ total estimated breakage to be recognized}$$

$$[\$48 / (\$75 - \$3)] = 67\% \text{ estimated redemption to date}$$

$$(\$3 \times 67\%) = \$2 \text{ breakage to be recognized at the time of redemption}$$

GTL will continue to recognize revenue for breakage amounts as the remaining gift card balance is redeemed by the customer. Once GTL determines that the likelihood of the customer redeeming any remaining balance on the gift card is remote, GTL will recognize revenue and remove the contract liability for the remaining amount.

However, if the prepayment element (e.g., the sale of a gift card, loyalty points) is part of a multiple-element arrangement, it is unclear how the guidance on breakage is meant to interact with the guidance on the determination of a standalone selling price. That is, the guidance on breakage would suggest that an entity should establish a liability for the full amount of the prepayment and recognize breakage on that liability proportionate to the revenue being recognized. This is straightforward in contracts with only a single element (e.g., a retailer sells a gift card to a customer).

In multiple-element arrangements, the entity must determine the standalone selling price of each performance obligation, including the prepaid component. If the standalone selling price for the prepaid component is not directly observable (e.g., the price of loyalty points), the standard requires an entity to estimate it. In making this estimate, entities will likely take into consideration the likelihood that the customer ultimately will not request the services they have paid for in advance, or the potential breakage, as shown in Example 52 in the standard.

Considering the possible lack of redemption when estimating the standalone sales price will result in less revenue being allocated to the prepaid component. As a result, the deferred revenue associated with the prepaid component could be less than the contractual “prepayment” amount, which appears inconsistent with the guidance in the standard for these types of transactions.

How we see it

Retail and consumer product entities currently defer recognizing revenue from breakage indefinitely or until the gift card expiration date, unless an entity has enough experience to support a conclusion that it is unlikely the balances will be used for future purchases (in which case an estimate of breakage is recorded).

The new guidance requires entities to estimate breakage (if they are entitled to breakage) and include such amounts in their transaction price (after adjusting the amounts for the constraint on variable consideration, if necessary). Although authoritative guidance does not exist under current US GAAP, entities that estimate breakage would most likely reach conclusions under the new standard that would be similar to those they reach today. Entities that do not estimate breakage today will face a change when they implement the new standard.

Omni-channel considerations

As retailers enhance their supply chain by integrating online and mobile sales and inventory channels with traditional brick and mortar locations to create multiple sales channels (e.g., buy from the retailer’s website/app or in its physical store), retailers will need to evaluate when control of the products transfers to the customer (i.e., at what point revenue should be recognized for the sale). Retailers will also need to evaluate whether the contract with the customer includes multiple performance obligations and when control of each performance obligation transfers to the customer.

The example below illustrates the sale of products with multiple sales channels.

Illustration 3 – Omni-channel considerations

XYZ Retailer (XYZ), a discount retailer, offers a promotion for customers to purchase a DVD of a new movie ahead of its release to the general public for \$40. The promotion includes the DVD that customers may pick up in stores after the movie is released to the general public and a one-time on-demand download (available for 24 hours after download) of the movie, which customers can download and view prior to obtaining the DVD version in stores.

Assume XYZ determines there are two performance obligations in the contract with a customer (the DVD and the download) and estimates a transaction price of \$40 (after applying the constraint). Because XYZ routinely sells new release DVDs to its customers, it determines the standalone selling price (i.e., observable price) for the DVD is \$30. In addition, through its online television and movie subscription business, XYZ routinely sells new release movies for download and, as a result, determines the standalone selling price for the one-time download is \$10. In this example, XYZ will recognize revenue based on the contract amount for each performance obligation because there is no discount in the arrangement.

At the time of purchase, XYZ does not recognize any revenue because XYZ has not satisfied either of its performance obligations. The revenue recognition of the \$10 for the download of the movie would follow the guidance for accounting for distinct licenses of intellectual products, discussed below. In addition, XYZ will recognize revenue of \$30 for the DVD when the customer obtains control of the physical product (DVD) at the store.

How we see it

Retail and consumer products entities that offer goods or services through multiple delivery channels will need to consider the promised goods or services to determine whether multiple performance obligations exist. If more than one performance obligation exists, entities will need to determine the number of performance obligations and when each performance obligation has been satisfied (i.e., when revenue should be recognized).

Other measurement and recognition topics

Consideration received from a vendor

Retailers often receive cash consideration from their vendors as sales incentives (e.g., slotting fees, rebates). Under today's guidance, the consideration received is presumed to be a reduction in the cost basis of the retailer's inventory (and recognized in cost of sales once the products are transferred to the retailer's customer or milestones are achieved). The presumption can be overcome in certain circumstances.

The new standard is not expected to change the accounting for such sales incentives. However, the applicable paragraphs were moved from the revenue guidance in ASC 605-50 to ASC 705-20 and amended to conform to the language of the new revenue standard. The revenue line item is not affected by the change.

Consideration received from a vendor for manufacturer coupons

Manufacturers often will offer directly to consumers sales discounts and incentives on products sold through retailers (i.e., resellers). For example, a manufacturer offers a rebate or provides a coupon to the consumer to stimulate consumer demand for their products. Retailers may honor the manufacturer incentives as a reduction of the price paid by consumers and seek reimbursement for the incentive directly from the manufacturer. Under today's guidance, when a consumer redeems a manufacturer's coupon at the time of product purchase from a retailer, the retailer generally recognizes revenue at the gross amount of cash received from the consumer and the manufacturer (i.e., the full selling price of the product), if certain criteria are met.

The new standard is not expected to significantly change the accounting for such sales incentives. However, the applicable paragraphs were moved from the revenue guidance in ASC 605-50 to ASC 705-20 and amended to conform to the language of the new revenue standard. Retailers that meet the following criteria will record revenue for the full selling price (i.e., the gross amount):

- ▶ The incentive can be tendered by a consumer at any retailer in partial payment of the price charged by the retailer for the product.
- ▶ The retailer receives reimbursement from the manufacturer based on the face amount of incentive.
- ▶ The terms of the reimbursement to the retailer for the sales incentive may only be determined by the terms of the incentive offered to consumers.

- ▶ The retailer is subject to an agency relationship with the manufacturer in the transaction between the vendor and the consumer.

If the sales incentive does not meet all of the criteria above, retailers are required to account for the incentive as a reduction of the purchase price of the goods or services acquired from the vendor.

Licensing arrangements

Many retail and consumer products entities grant licenses of intellectual property (IP). These arrangements are typically royalty-based arrangements under which the entity will provide a third party a license to use certain IP (e.g., trademarks, trade names, copyrights) in connection with the operation of a retail store or manufacture and sale of designated products. These contracts may include contractually guaranteed minimum royalty levels or specify that royalty payments will be based on a percentage of actual sales. Under today's guidance, entities generally record revenue from licensing arrangements when the royalties become due within the terms of the underlying contracts.

Sales- and usage-based royalties

The standard provides explicit guidance for recognizing sales- and usage-based royalties from licenses of IP. Specifically, the standard creates an exception to the requirement to estimate variable consideration for transactions that involve sales- and usage-based royalties resulting from the licenses of IP. As a result, these amounts are recognized only upon the later of when the sale or usage occurs or the performance obligations to which some or all of the sales- or usage-based royalties have been allocated has been satisfied (or partially satisfied). This exception may result in accounting that is similar to current practice.

However, it is unclear how this exception will be applied in contracts that contain more than a license of intellectual property. For example, it is unclear whether this exception will apply to royalties that relate to both licensed IP and other goods or services in a contract (e.g., a contract with two performance obligations such as a distinct franchise license and consulting or training services that would be provided over time and would affect the amount of royalties earned). The TRG has discussed a number of views, including whether the exception should apply solely to a license that is a separate performance obligation or whether it should apply regardless of whether the royalty also relates to a non-license good or service or relates to licensed IP that is bundled with another promised good or service in the arrangement. It is not yet clear whether the Boards will provide additional guidance.

Other license arrangements

For licensing arrangements that include other forms of consideration (e.g., a license arrangement with a flat fee or a guaranteed minimum in a sales-based royalty arrangement), an entity will first have to determine whether the license of IP is distinct because the new standard includes specific guidance on how to account for distinct licenses of IP. For licenses that are not distinct, an entity will follow the guidance in the overall model to account for the bundled performance obligation (that contains a license and at least one other good or service).

For distinct licenses of IP, an entity must determine whether the license transfers to the customer at a point in time or over time by considering the nature of the promise to the customer. The standard states that entities provide their customers with either:

- ▶ A right to access the entity's intellectual property as it exists throughout the license period, including any changes to that intellectual property, which should be reflected as revenue recognized over time

An entity must determine whether a distinct IP license transfers to the customer at a point in time or over time.

- ▶ A right to use the entity's intellectual property as it exists at the point in time in which the license is granted, which should be reflected as revenue recognized at a point in time

A license is a promise to provide a *right to access* if all of the following criteria are met:

- ▶ The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights.
- ▶ The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities.
- ▶ The entity's activities do not result in the transfer of a good or a service to the customer as those activities occur (i.e., does not represent a separate performance obligation).

If the license does not meet all three criteria, the license agreement provides a *right to use* the license, and the entity would recognize revenue at the point in time when the control of the license transfers to the customer.

The Boards noted in the Basis for Conclusions that the existence of a shared economic interest between the parties (e.g., sales- or usage-based royalties) may be an indicator that the customer has a reasonable expectation that the entity will undertake such activities.

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

Illustration 4 – Licensing arrangement (sales-based royalty)

SSR Co. (SSR), a soft drink company, enters in to a licensing arrangement with Fabrics Worldwide Inc. (FWI), an apparel company. The licensing arrangement 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 calculated from 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 arrangements with other apparel companies. FWI will provide updated sales data on a quarterly basis.

SSR has determined the license is a distinct performance obligation. Assume for purposes of this example that SSR determines the license provides FWI with a right to use the IP (over time) based on the following considerations:

- ▶ SSR will undertake activities that will affect the IP to which FWI has rights.
- ▶ The rights granted by the license directly expose FWI to positive or negative effects of changes in the activities on the IP.
- ▶ SSR activities do not transfer a separate good or service to FWI as those activities occur, even if FWI may benefit from the activities.

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. The sales-based royalties (variable consideration) are excluded from the transaction price until the underlying sales occur, at which point revenues from the sales-based royalties are recognized.

Up-front fees in franchising arrangements

Retailers and consumer products entities may have franchising arrangements from which they receive rent and royalties based on a percentage of sales, along with fees received upon the opening of a new restaurant or the granting of a new franchise term. Under current guidance, entities generally recognize revenue from rent and sales-based royalties in the period earned (i.e., when sales occur). If a franchising arrangement includes nonrefundable up-front fees, entities either: (1) record revenue from the nonrefundable up-front fees when the entity has performed all initial services required (if the up-front fees are related to a separate element in the arrangement that is satisfied at the onset of the arrangement) or (2) capitalize the up-front fee and recognize the revenue over the contract term or as other identified elements in the contract are satisfied.

Under the new standard, entities must evaluate whether up-front fees relate to the transfer of a promised good or service, which could represent an advance payment for future goods or services. Some entities may conclude that the nonrefundable up-front fees are related to an initial service (i.e., a performance obligation) that is satisfied at the onset of the arrangement, for which revenue should be allocated and recognized. Others may conclude that the up-front fees received are not related to an initial service but instead to performance obligations satisfied throughout the life of the franchise agreement. Alternatively, entities may charge an up-front fee in part as compensation for activities that they must undertake to fulfill a contract (e.g., administrative, set-up activities) that do not transfer a good or service to a customer. For example, a retail or consumer products entity may need to perform various administrative tasks to set up a franchising agreement, such as marketing campaigns, which generally do not transfer a service to the customer as they are performed. The entity should disregard such activities when measuring progress toward completion of a performance obligation.

The new guidance requires that the up-front fees be assessed 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. The example below illustrates the accounting for a franchise arrangement with a nonrefundable up-front fee.

Illustration 5 – Franchising arrangement with a nonrefundable up-front fee

Foodie operates and franchises restaurants around the world. As part of its franchise agreement, Foodie requires a franchisee to pay a nonrefundable up-front franchise fee of \$95,000 upon opening a restaurant and ongoing payments of royalties based on a percentage of sales. As part of the franchise agreement, Foodie provides pre-opening services, including supply and installation of cooking equipment and cash registers, valued at \$30,000 (i.e., the standalone selling price of the pre-opening services). In addition, the franchise agreement includes the conveyance of a license of IP (i.e., Foodie's trademark and trade name) to the franchisee. Assume that Foodie has determined the license provides a right to use the IP over time. Foodie has determined the standalone selling price of the license is \$70,000. The franchise agreement has a term of 15 years.

Foodie evaluates the arrangement and determines it meets the criteria to be accounted for as a contract with a customer. Foodie determines its pre-opening services and license of IP are each distinct and therefore should be accounted for as separate performance obligations. Foodie recognizes \$28,500 [$(\$30,000 / \$100,000) * \$95,000$] of revenue at a point in time when the performance obligation to supply and install cooking equipment and cash registers is satisfied. Foodie will recognize revenue associated with the licensed IP, \$66,500 [$(\$70,000 / \$100,000) * \$95,000$], ratably over the 15-year license term (i.e., the period of time the franchisee will have access to and use of Foodie's IP), as the entity determined the license provided a right to use the IP over the license term.

Warranty arrangements

Retail and consumer products entities often sell products with warranties, which can be either explicitly stated in the contract or implied based on the entity's customary business practices. The new revenue standard identifies two types of warranties:

- ▶ Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (i.e., service-type warranties)
- ▶ Warranties that promise the customer that the delivered product is as specified in the contract (i.e., assurance-type warranties)

Service-type warranties

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the warranty based on its estimated standalone selling price. The entity then recognizes revenue allocated to the warranty over the period the warranty service is provided. The entity may need to exercise judgment to determine the appropriate pattern of revenue recognition associated with service-type warranties.

Assurance-type warranties

The Boards concluded that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a guarantee of quality. Under the standard, these types of warranties are accounted for as warranty obligations, and the estimated cost of satisfying them is accrued in accordance with the current guidance in ASC 460-10 on guarantees. Once recorded, the warranty liability should be assessed on an ongoing basis to ensure that changes in the seller's environment or obligations are reflected in the recorded liability. The liability should be adjusted (with the offset recorded as an adjustment to costs of sales) as changes in estimates occur.

Contracts that contain both assurance- and service-type warranties

Retail and consumer products entities may enter into contracts that include both assurance-type and service-type warranties. If an entity provides both types of warranties within a contract, it should accrue for the expected costs associated with the assurance-type warranty and defer the revenue for the service-type warranty.

If the entity cannot reasonably account for assurance-type and service-type warranties within a contract separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognized over the period the warranty services are provided).

The example below illustrates the accounting for a contract with a service-type and assurance-type warranty.

Illustration 6 – Service-type and assurance-type warranty – consumer products entity

Toolco (TUL), a tool manufacturer, sells 100 cordless electric drills to HWS Hardware Store (HWS) for \$50 each. Each drill costs TUL \$35. TUL includes a warranty with the sale of each drill to a customer, which provides for full replacement of the drill if it fails to work properly within two years from the date of purchase by the consumer. TUL considers any defects in the drills that arise within 90 days from the date of purchase by the consumer to be a failure to comply with the agreed-upon specifications (i.e., related to a defect that existed at the time of sale). TUL considers the warranty it provides beyond the first 90 days to be a distinct service.

In this example, TUL provides both an assurance-type warranty (the warranty covering defects in the first 90 days after the sale) and a service-type warranty (the warranty covering defects arising during the remaining 21 months of a two-year warranty period).

The total transaction price for the sale of a drill and the service-type warranty is \$50. TUL estimates the standalone selling price of each is \$40 and \$10, respectively. Based on past experience, TUL also estimates that 2% of all electric drills it sells will fail to comply with agreed-upon specifications within the first 90 days, which will require TUL to replace the drills (at a cost of \$35 per drill).

TUL records the following journal entry to record the sale of 100 drills to HWS and the related warranty liabilities:

Dr. Cash/receivables	\$	5,000	
Dr. Warranty expense		70	
Cr. Revenue	\$		4,000
Cr. Warranty liability (assurance-type warranty)			70
Cr. Contract liability (service-type warranty)			1,000

TUL also records the following journal entry to record the cost of sales and the relief of inventory:

Dr. Cost of sales	\$	3,500	
Cr. Inventory			\$ 3,500

TUL will relieve the warranty liability for the assurance-type warranty as actual warranty costs are incurred (to replace the defective drills) during the initial 90-day quality-assurance period. For the service-type warranty, TUL will relieve the contract liability and recognize revenue over the 21-month warranty period that follows the initial 90-day quality assurance period (presumably straight-line over the period, unless a different pattern is expected). Costs associated with providing the service-type warranty will be expensed as incurred.

How we see it

Retail and consumer products entities may need to exercise significant judgment when determining whether a warranty is an assurance-type or service-type warranty. This evaluation may be affected by several factors, including common warranty practices within its industry. For example, a manufacturer of televisions may provide a three-year warranty on its high-end 3D HD televisions and a one-year warranty on its low-end plasma 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 defects would take longer to appear. In contrast, the manufacturer might compare the warranty with those offered by its competitors 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.

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.

Sales of nonfinancial assets (including real estate)

Retail and consumer products entities may dispose of real estate (e.g., manufacturing and distribution facilities, retail stores, excess parcels of land) and/or integral equipment following the prescriptive real estate sales rules that exist in today's guidance. The new model (located in ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*) for derecognizing and recording the gain or loss on the sale of nonfinancial assets (including real estate) to noncustomers differs significantly from today's guidance and uses the measurement and recognition principles of the new revenue standard. As a result, any gains resulting from the sales of nonfinancial assets may be recognized sooner than they are today. Refer to our Technical Line, [The new revenue recognition standard – real estate](#) (SCORE No. BB2811) for more information.

Disclosures

In response to criticism that today's revenue recognition disclosures are inadequate, the Boards sought to create a comprehensive and coherent set of disclosures. As a result, and to be consistent with other recent standards, the guidance includes an overall objective for these disclosures, as follows:

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers – Overall

Disclosure

606-10-50-1

The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- a. Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)
- b. The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)
- c. Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).

Disclosure requirements differ for public and nonpublic entities. The disclosures are required for and as of each annual period for which a statement of comprehensive income and a statement of financial position are presented. Interim disclosures also are required for entities preparing interim financial statements.

The annual and interim disclosure requirements, as well as guidance on transition disclosures required upon adoption of the new standard, are discussed in our Technical Line, [A closer look at the new revenue recognition standard](#) (SCORE No. BB2771).

Next steps

- ▶ Entities should perform a preliminary assessment of how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the standard and make sure they have processes, systems and controls in place to collect the necessary information to implement it, even if their accounting results won't change significantly or at all.
- ▶ Entities also may want to monitor the discussions of the Boards, the SEC staff and the TRG.
- ▶ Public entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SAB Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

- ¹ The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following: (1) a public business entity, (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements with the SEC.

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