

Technical Line

FASB – proposed guidance

Revenue recognition proposal – retail and consumer products

In this issue:

Overview	1
Normal product sales.....	2
Rights of return	2
Product warranties.....	5
Consumer products companies	5
Retailers	7
Sales incentives and vendor allowances.....	8
Consumer products companies	9
Retailers	11
Licenses and rights of use	13
Gift cards	14
Initial accounting upon issuance	14
Subsequent accounting.....	14
Accounting for “breakage”.....	14
Other considerations	16

What you need to know

- ▶ The FASB and the IASB issued a second exposure draft of their joint revenue recognition model that is closer to current US GAAP than their 2010 proposal.
- ▶ The revised model would apply to all retail and consumer products entities and would replace all of the revenue guidance in the FASB Accounting Standards Codification.
- ▶ The proposed guidance would not significantly change revenue recognition for retail and consumer products companies; however, there would be differences from current practice in some areas.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) jointly issued a revised proposal to supersede virtually all existing revenue guidance under US GAAP and IFRS.

The new Exposure Draft (ED) is based on the five-step model the Boards initially proposed in 2010. Our Technical Line, *Double exposure: the revised revenue recognition proposal* (SCORE No. BB2231) (general Technical Line), discusses those steps in detail.

This publication supplements our general Technical Line and should be read in connection with it. In this publication, we focus on the following areas that we expect to be of interest to retail and consumer products companies as they consider the potential effects of the proposal:

- ▶ Normal product sales
- ▶ Rights of return

- ▶ Product warranties
- ▶ Sales incentives and vendor allowances
- ▶ Licenses and rights of use
- ▶ Gift cards

We encourage retail and consumer products companies to read this supplement carefully, consider the potential effects on their revenue recognition practices and express any concerns to the FASB. This publication does not represent our final or formal views because the proposal could change as the Boards deliberate further.

Normal product sales

Under the proposed model, revenue would be recognized when the customer obtains control of a good or service from the seller. Under existing US GAAP, revenue is recognized when the risks and rewards of ownership pass to the customer. The timing of revenue recognition by retail and consumer products companies for a normal product sale generally would not change under the proposed guidance because the transfer of control of the goods to the customer would generally occur at the same time as the transfer of risks and rewards.

Rights of return

It is common practice in the retail and consumer products industries to sell goods with a right of return. The Boards concluded that an entity should not recognize revenue for sales that are expected to fail because the customer exercises its right to return the goods.

Accordingly, under the proposed model, retail and consumer products companies would need to estimate their expected returns and recognize revenue net of the expected returns (i.e., based on the amounts they are reasonably assured to be entitled to through the end of the return period, considering the products expected to be returned).

An entity's estimate of its expected returns would be determined using either (1) an expected value (probability-weighted) approach or (2) the most likely amount to be received, whichever better predicts the amount of revenue (net of returns) to which the entity will be entitled. Use of the expected value approach may result in more complex calculations for retail and consumer products companies offering rights of return, but may not result in a materially different estimate of returns from current practice, under which the estimate is generally based on historical returns. Section 4.1 of our general Technical Line contains further discussion of variable consideration.

How would the balance sheets of retail and consumer products companies be affected? Consistent with current practice under US GAAP, retail and consumer products companies would record a liability on their balance sheets representing their obligation related to the expected returns. They would also record an asset for their right to recover the goods expected to be returned by the customer. While under current practice this amount generally is included in inventory, the proposed guidance appears to require the presentation of the return asset separately from inventory.

Revenue would be recognized net of expected returns, using either an "expected value" or "most likely amount" approach.

How we see it

The accounting for products sold with a right of return under the proposed guidance is largely consistent with that under current US GAAP. However, as in other areas that involve variable consideration, retail and consumer products companies would need to determine whether using an expected value approach or the most likely amount would better predict the amount of returns. In practice, we believe many companies may find the use of the most likely amount to be simpler and closer to current practice.

The presentation of the return asset on the balance sheet separately from inventory may appear on the surface to be nothing more than an issue of geography. However, this return asset would be subject to impairment testing. As a result, retail and consumer products companies would need to periodically evaluate the return asset for impairment, as opposed to considering the asset as part of their overall evaluation of inventory for impairment.

Illustration 1 - Right of return

ABC Apparel Co. (ABC), an apparel retailer, has a 30-day return policy under which a customer can take one of the following actions:

- Exchange a product for another product of the same type, quality, condition and price
- Return the product for a full refund

The policy requires that all products exchanged or returned must be “like new” with original tags.

ABC sells 1,000 units of a particular product at a selling price of \$200 each, with a cost of \$100 each.

Using an expected value approach, ABC estimates that there is a 20% probability that no products will be returned, a 20% probability that 1% of its products will be returned, a 50% probability that 2% of its products will be returned and a 10% probability that 3% of its products will be returned. Accordingly, ABC’s return estimate is 1.5%, calculated as follows:

$$(0.2 \times 0\%) + (0.2 \times 1\%) + (0.5 \times 2\%) + (0.1 \times 3\%) = 1.5\%$$

ABC also estimates that 1% of its products will be exchanged for another product of the same type, quality, condition and price.

ABC recognizes revenue for the products that are not expected to be returned. Note that 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 proposed requirements. Accordingly, ABC does not account for the 1% of products it expects customers to exchange as expected returns.

Illustration 1 - Right of return (continued)

However, the 1.5% of products that ABC estimates will be returned by the customer for a full refund should be treated as expected returns under the proposed requirements. Accordingly, ABC recognizes revenue for only the 98.5% of products that it expects will not be returned, resulting in revenue recognition of \$197,000, calculated as follows:

$$(1,000 \text{ units} \times \$200 \text{ price per unit}) \times 98.5\% = \$197,000$$

ABC also records a refund liability for the products expected to be returned. ABC measures this refund liability at the expected value of the amount that ABC would refund to its customers for the returns. In this example, that refund liability is initially measured at \$3,000, calculated as follows:

$$(1,000 \text{ units} \times \$200 \text{ price per unit}) \times 1.5\% = \$3,000$$

The result is that ABC recognizes its sales net of the amount of expected returns.

Finally, ABC also records an asset and a corresponding adjustment to cost of sales for its right to recover the returned products from its customers upon settling the refund liability (i.e., refunding the customer's money and accepting the returned product). ABC measures this asset at the former carrying amount of the inventory, less any expected costs to recover the products, including any potential decreases in the value of the products to ABC (for purposes of this example, assume that ABC estimates the cost of recovering the products to be insignificant). In this example, that asset is initially measured at \$1,500, calculated as follows:

$$(1,000 \text{ units} \times \$100 \text{ cost per unit}) \times 1.5\% = \$1,500$$

ABC records the following journal entries in the above example:

Dr. Cash	200,000	
Cr. Sales		197,000
Cr. Refund liability		3,000

To record revenue and refund liability

Dr. Cost of sales	98,500	
Dr. Return asset	1,500	
Cr. Inventory		100,000

To record cost of sales, relief of inventory and the return right

ABC would update the measurement of its refund liability (and the return asset included in inventory) as needed at the end of each reporting period for any changes in estimates or assumptions.

Product warranties

Retail and consumer products companies often sell products with warranties providing coverage that those products will be free of defects at the time of sale or for a specified period thereafter.

As described in our general Technical Line, the proposed guidance distinguishes between two types of warranties:

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

The accounting treatment for these two types of warranties would differ significantly under the proposal. An assurance-type warranty would give rise to a warranty obligation (but not a separate performance obligation for revenue recognition purposes) and would be accounted for using a cost accrual approach. A service-type warranty would be deemed a separate performance obligation and would require a deferral of revenue, based on a relative selling price allocation.

A warranty also may have terms such that it contains both an assurance-type warranty and a service-type warranty, which would require separate accounting for each type. Note, however, that if the warranties cannot be reasonably accounted for separately, they then would be accounted for together as a single performance obligation, with revenue deferred and recognized over the period the warranty services are provided.

The specific accounting treatment for these two types of warranties by consumer products companies and retailers is described separately below.

Consumer products companies

When a consumer products company sells goods to a retailer, and those goods are covered by a warranty, the consumer products company would most likely have two contracts to consider under the proposed revenue recognition model: (1) a contract to provide the goods to the retailer and (2) a contract to fulfill its warranty obligation to the consumer who buys the product from the retailer. The proposed revenue recognition guidance for warranties would apply to the consumer products company's warranty obligation to the consumer. As such, revenue recognition for a service-type warranty would not begin until the consumer purchases the product.

Illustration 2 - Warranty

Toolco (TUL), a tool manufacturer, sells 100 cordless electric drills to HWS Hardware Store (HWS) for \$50 each. The drills cost TUL \$35 each. TUL includes a warranty with each drill, which provides for a full replacement of the drill if the unit 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 failure to comply with agreed-upon specifications. TUL considers the warranty it provides beyond the first 90 days to be a separate service.

The ED distinguishes between two types of warranties, with different accounting required for each type.

Illustration 2 - Warranty (continued)

In this example, TUL provides both types of warranties discussed above. The warranty covering defects in the first 90 days after the sale is an assurance-type warranty, while the warranty covering defects arising during the remaining 21 months of the two-year warranty period is a service-type warranty.

Based on past experience and using an expected value approach, TUL estimates that 2% of all the electric drills it sells will fail to comply with agreed-upon specifications in the first 90 days, which will require TUL to replace the drills. Additionally, based on a relative standalone selling price allocation, TUL estimates that of the total transaction price of \$50 for a drill, \$40 should be allocated to the drill and \$10 should be allocated to the service-type warranty for the drill. (See Section 5 of our general Technical Line for further discussion of the allocation of the transaction price to separate performance obligations.)

TUL records the following journal entry to record the sale of the drills to HWS and the related obligation to replace defective drills in the above example (where the warranty expense and the related obligation would be calculated as \$35 x 100 drills x 2%):

Dr. Cash	5,000	
Dr. Warranty expense	70	
Cr. Sales		4,000
Cr. Warranty obligation (assurance-type warranty)		70
Cr. Contract liability (service-type warranty)		1,000
<i>To record revenue and warranty liability</i>		

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

Dr. Cost of sales	3,500	
Cr. Inventory		3,500
<i>To record cost of sales and relief of inventory</i>		

Subsequently, TUL will relieve the warranty obligation for the assurance-type warranty as it replaces any 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 subsequent to the initial 90-day quality assurance period (presumably straight-line over the period, unless a different pattern is expected).

Another important consideration with respect to warranties under the proposed guidance is the accounting for changes in the original estimates for the warranty obligation, which is different for each type of warranty. For assurance-type warranties, an entity would reflect any revisions to its original estimates as an adjustment to the recorded cost accrual. On the other hand, an entity would not modify the revenue allocated to a service-type warranty for changes in its original estimates.

Section 7.1 of our general Technical Line also discusses the accounting for changes in expected costs to satisfy a service-type warranty performance obligation. When service-type warranty cost estimates increase, an entity must assess whether the cost increase has created an onerous performance obligation. See Section 7.2 of our general Technical Line for further discussion of onerous performance obligations.

How we see it

If a warranty provides a service to the customer in addition to assurance about agreed-upon specifications, an entity must separately account for both an assurance-type warranty (cost accrual) and a service-type warranty (revenue deferral). Consumer products companies likely would find it challenging to estimate a standalone selling price if they do not sell service-type warranties on a standalone basis.

Companies that sell products to resellers and provide service-type warranties also would need to remember that the warranty period over which they would recognize revenue would not begin until the product is purchased by the consumer. This may require consumer products companies to develop a better means of tracking the beginning of the warranty period for a service-type warranty than they have now.

Given the importance of distinguishing between different types of warranties, companies also may need to consider enhancing processes and controls. They may need to involve operational personnel and the legal department in any analysis.

Retailers

While retailers sell many products with warranties, the warranty obligations are often the responsibility of the manufacturer of the product or a third party. However, in some cases, retailers provide warranty coverage for their products and also may sell extended warranties for the products they sell.

As is the case today under US GAAP, retailers that provide warranties would have to determine whether they are the legal obligor under the warranty arrangement to determine the appropriate accounting treatment under the proposal. If they are the obligor, retailers would follow the same considerations outlined above for consumer products companies, including deferring revenue for service-type warranties instead of simply accruing costs. Unlike the current treatment under US GAAP, if a retailer sells an extended warranty, the amount allocated to that extended warranty is not simply the contractual price of the warranty. Instead, it would be the amount of allocated transaction price based on a relative standalone selling price allocation.

Illustration 3 - Warranty

Top Tech Universe (TTU), an electronics retailer, sells a new HDTV, together with an extended warranty, to a customer for \$525. The HDTV comes with a manufacturer's 60-day assurance-type warranty that the HDTV will comply with agreed-upon specifications. This assurance-type warranty is the sole responsibility of the HDTV manufacturer. The extended (service-type) warranty, which TTU also sells separately from the HDTV, covers a three-year period starting from the end of the 60-day manufacturer's assurance-type warranty. TTU is the primary obligor under this extended warranty.

TTU sells the HDTV and extended warranty separately for \$500 and \$40, respectively. Accordingly, using a relative standalone selling price allocation based on the standalone selling prices of the HDTV and the extended warranty, TTU allocates \$39 of the total \$525 transaction price to the extended warranty, calculated as follows:

$$\$40 / (\$500 + 40) = 7.4\% \text{ (percentage of the total transaction price to be allocated to the extended warranty)}$$

$$\$525 \text{ transaction price} \times 7.4\% = \$39$$

TTU records the following journal entry to record the sale of the HDTV and extended warranty in the above example:

Dr. Cash	525	
Cr. Sales		486
Cr. Contract liability (service-type warranty)		39
<i>To record revenue and warranty liability</i>		

TTU will reduce the contract liability for the service-type warranty and recognize revenue over the extended warranty period (presumably straight-line over the three-year period, unless a different pattern is expected).

Note that in this example, TTU does not record any cost accrual for the assurance-type warranty because that warranty is the responsibility of the HDTV manufacturer.

Sales incentives and vendor allowances

Various types of sales incentives and vendor allowances are common in the retail and consumer products industries. Consumer products companies provide retailers or other customers with different forms of vendor allowances, such as volume discounts, price protection, slotting fees, co-op advertising and promotional allowances, among others. Additionally, consumer products companies commonly provide sales incentives directly to the end-user consumers of their products in the form of coupons and rebates. Retailers commonly provide their customers with sales incentives including free products, rebates, coupons and other types of promotions. We will look at how some of these types of arrangements would be accounted for under the proposed model from the perspective of both the consumer products company and the retailer.

Consumer products companies

Under current US GAAP, a vendor typically treats cash consideration paid or payable to a customer as a reduction of revenue unless there is an identifiable benefit received from the customer. Under the proposed model, consideration paid or payable to the customer, depending on the nature of the arrangement, could represent:

- ▶ A discount or refund for goods or services provided to the customer, which would be accounted for as a reduction of revenue
- ▶ A payment for one or more distinct goods or services received from the customer, which would generally be expensed (or, in certain cases, capitalized) in accordance with other US GAAP guidance
- ▶ A combination of both

How we see it

We expect that many types of arrangements involving consideration paid or payable by a consumer products company to a retailer or other customer in the form of volume discounts, price protection, slotting fees, coupons and other similar arrangements would be viewed as a discount or refund for the goods sold to the customer. Generally, for these types of arrangements, the payment to the customer is so closely and directly tied to the goods sold to the customer that it is unlikely that the vendor is receiving any distinct good or service from its customer. Thus, the consumer products company would continue to account for many of these types of arrangements as a reduction of revenue.

For example, in the case of slotting fees paid by a vendor to a retailer, although not specifically addressed in the ED, we believe in most cases it is unlikely that such fees would represent a payment in exchange for the retailer providing a distinct good or service to the vendor. Therefore, they should be treated as a reduction of revenue, as is generally the case in current practice.

Under the proposed model, a consumer products company might determine that certain other types of arrangements, such as co-op advertising, may include payments (or other forms of consideration) to the customer for a distinct good or service (e.g., advertising). If this were the case, the company generally would account for these payments as an expense in its income statement. The determination of whether a good or service received from the customer is distinct may not always be the same as determining whether the company has received an identifiable benefit from the customer under current US GAAP.

In some cases, the amount of consideration received from a customer and any consideration paid to that customer may be linked, such that the consideration is treated as both (1) a reduction of the transaction price and (2) a payment to the customer for a distinct good or service. In these situations, any excess consideration payable over the fair value of the distinct good or service received from the customer would reduce the transaction price (i.e., reduce revenue).

An important consideration with respect to sales incentives and vendor allowances is that arrangements with customers involving discounts, rebates, refunds and other incentives are often structured so that, at inception, a portion of the transaction price is variable. The issue of variable consideration could exist when certain performance conditions (e.g., a minimum level of purchases) must be met by the customer and there is uncertainty about the outcome. These types of programs would need to be evaluated as consideration paid or payable to a customer and, to the extent they result in a reduction to the transaction price, would be subject to the proposed guidance on variable consideration discussed above.

With respect to timing, when consideration payable to a customer is recognized as a reduction of revenue under the proposed guidance, a consumer products company would recognize the reduction of revenue at the later of when it transfers the related goods to the customer or promises to pay the consideration.

Illustration 4 - Volume discount

SPO Co. (SPO), a beverage company, sells sports drinks to GRO Co. (GRO), a grocer. SPO and GRO agree to a one-year purchase agreement under which SPO will sell the sports drinks to GRO at \$10 per 12-pack case, with volume discounts available to GRO if it purchases certain minimum quantities from SPO, as follows:

- ▶ If GRO purchases less than 1,000 cases from SPO, GRO will receive no discount
- ▶ If GRO purchases 1,000 cases from SPO, GRO will receive a 10% discount
- ▶ If GRO purchases 2,000 cases from SPO, GRO will receive a 20% discount
- ▶ If GRO purchases 3,000 cases from SPO, GRO will receive a 30% discount

Due to the volume discounts available to GRO under the purchase agreement, the transaction price is variable at the inception of the agreement. In this example, assume that SPO determines that the expected value approach will better predict the consideration it expects to receive from GRO. Therefore, SPO must estimate the probability of GRO purchasing the required number of cases to qualify for each of the discounts.

SPO estimates the following probabilities:

- ▶ SPO estimates a 50% probability that GRO will purchase less than 1,000 cases (no discount)
- ▶ SPO estimates a 25% probability that GRO will purchase 1,000 cases (10% discount)
- ▶ SPO estimates a 15% probability that GRO will purchase 2,000 cases (20% discount)
- ▶ SPO estimates a 10% probability that GRO will purchase 3,000 cases (30% discount)

Therefore, the estimated volume discount is 8.5%, calculated as follows:

$$(0.50 \times 0) + (0.25 \times 10\%) + (0.15 \times 20\%) + (0.10 \times 30\%) = 8.5\%$$

Illustration 4 - Volume discount (continued)

Six months into the purchase agreement, GRO has purchased 500 cases. Assume SPO has not changed its estimate of the 8.5% discount expected to be earned by GRO (as SPO anticipates that GRO will begin purchasing increased quantities of the sports drinks for sale in additional markets). SPO records sales of \$4,575 and a liability for the estimated volume discount to GRO of \$425, calculated as follows:

500 cases x \$10 per case = \$5,000
 \$5,000 x 8.5% = \$425 volume discount liability
 \$5,000 - \$425 = \$4,575 sales amount

SPO records the following journal entry:

Dr. Cash	5,000	
Cr. Sales		4,575
Cr. Volume discount liability		425

To record revenue and estimated volume discount liability

During the last six months of the purchasing agreement, GRO purchases an additional 700 cases (after deciding not to sell SPO's sports drinks in additional markets), such that GRO earns a 10% discount because its purchases exceed 1,000 cases. SPO records sales of \$6,225 and \$775 to true-up the liability for the volume discount to GRO, calculated as follows:

700 cases x \$10 per case = \$7,000
 \$12,000 total x 10% = \$1,200 volume discount liability
 \$1,200 - \$425 previously recorded = \$775 liability true-up amount
 \$7,000 - \$775 = \$6,225 sales amount

SPO records the following journal entry to true-up the actual liability to the 10% discount:

Dr. Cash	7,000	
Cr. Sales		6,225
Cr. Volume discount liability		775

To record revenue and actual volume discount liability

For purposes of this example, assume that SPO then refunds the volume discount amount to GRO at the end of the one-year term of the purchase agreement. SPO records the following journal entry to record the refund to GRO:

Dr. Volume discount liability	775	
Cr. Cash		775

To record refund for volume discount

Retailers

Under current US GAAP, a customer (e.g., a retailer) typically treats cash consideration received from a vendor as a reduction of cost of sales when the related inventory is sold. As a consequence of the proposed revenue recognition guidance, we believe US GAAP guidance for the customer's accounting for

consideration received from a vendor will be amended to be consistent with the proposed guidance for a vendor's accounting for such consideration. In other words, the retailer, like the vendor, would determine whether the consideration received from the vendor represents a discount or refund for goods or services received from the vendor, a payment for distinct goods or services provided to the vendor or a combination of both.

For consideration paid or payable by a retailer to its customers, such as in the form of discounts, coupons or free products, a retailer generally would follow the same guidance as described above for vendors providing consideration to their customers.

How we see it

Similar to the accounting by a vendor, the accounting by a retailer would not change significantly under the proposed model for many of the common types of vendor allowance arrangements. Because the retailer's accounting for consideration received from a vendor is not specifically addressed in the ED itself, but instead will be addressed in the consequential amendments resulting from the ED, retailers may want to review these amendments (in addition to the ED) to further evaluate any potential changes from current practice.

One potential area that may change is a retailer's characterization of sales incentives offered to customers by manufacturers, such as a manufacturer's coupon. Under current US GAAP, a specific exception is provided such that when a consumer redeems a manufacturer's coupon when purchasing a product from a retailer, the retailer recognizes revenue for the gross amount (as long as certain criteria are met). Absent a similar specific exception under the proposed guidance and related consequential amendments, we believe that the retailer may be required to recognize revenue net of the coupon amount and recognize the reimbursement from the manufacturer for the coupon as a reduction of cost of sales.

Illustration 5 - Co-op advertising

CHP Co. (CHP), a consumer products company, sells potato chips to RTR Co. (RTR), a retailer. CHP and RTR enter into a co-op advertising arrangement under which RTR will receive a 5% discount on its purchases from CHP in exchange for qualifying newspaper advertisements of RTR that feature CHP's products. Under the agreement, RTR must devote a half-page of its weekly newspaper ad circular to CHP products, and RTR must maintain documentation of the advertisements and related costs.

For the first month under the agreement, RTR incurred \$100,000 in total advertising costs for its weekly newspaper ad circulars, each of which devoted a half-page to CHP products, and purchased \$50,000 of CHP products. CHP paid RTR \$2,500 ($\$50,000 \times 5\%$) under the co-op advertising agreement. RTR estimated that of the \$100,000 in advertising costs incurred for the newspaper ads, the portion related to advertising for CHP was approximately 10% of the total (an estimated fair value of \$10,000). Therefore, the consideration received by RTR from CHP did not exceed the fair value of the advertising provided to CHP.

Illustration 5 - Co-op advertising (continued)

In this example, under the proposed model, the consideration received by RTR from CHP would appear to represent a payment for a distinct service (advertising) that RTR performed for CHP, as opposed to a discount or refund received by RTR for purchasing CHP's products. The proposed model states that the *vendor* (CHP) should account for this type of consideration "in the same way it accounts for other purchases from suppliers." Although not specifically addressed in the ED, based on the consequential amendments we expect to result from the ED, we believe that the *retailer* (RTR) would record this consideration as a reduction to its advertising costs, which would be consistent with current practice. If the amount of cash consideration received by RTR exceeded the fair value of the advertising costs for which it was reimbursed, the excess would be a reduction to cost of sales.

Licenses and rights of use

Granting licenses and other rights of use is common for many companies in the retail and consumer products industries. Under a licensing agreement, the licensor grants the licensee (its customer) the right to use the licensor's intellectual property (IP), such as a patent, trademark or copyright. Under the proposed guidance, licenses would be accounted for as a single performance obligation, with the licensor recognizing revenue when the licensee obtains the right to use and benefit from the licensed asset (i.e., when the customer obtains control of the license and can begin to use it).

How we see it

The proposed guidance should not result in a significant change in practice for retail and consumer products companies that currently recognize revenue at the time they grant a license. On the other hand, for retail and consumer products companies that currently recognize revenue over the license period, the recognition of revenue would be accelerated under the proposed guidance.

However, for arrangements involving uncertain consideration, the licensor would not recognize revenue until the uncertain consideration becomes reasonably assured. The ED explicitly states that revenue from licenses of intellectual property in the form of sales-based royalty payments would not be recognized until the uncertainty is resolved (i.e., subsequent sales occur). While this may not result in a significant change in the timing of revenue recognition from current practice, it highlights the importance of identifying uncertain consideration in an arrangement and its effect on revenue recognition under the proposed guidance.

Illustration 6 - Trademark

BRR Co. (BRR), a beer company, enters into a licensing agreement with TSR Co. (TSR), an apparel company. The licensing agreement gives TSR the right to use the BRR trademarked logo on a new line of TSR's T-shirts, hats and other apparel for a period of two years. In exchange for this right, TSR pays BRR a onetime fee of \$1 million at the inception of the licensing agreement.

In this example, the license creates a single performance obligation, which BRR satisfies when it transfers control of the trademark to TSR. BRR transfers control when it gives TSR the ability to direct the use of the BRR trademark and receive the benefits of its use, which occurs at the inception of the licensing agreement. Accordingly, BRR recognizes revenue of \$1 million at the inception of the agreement.

Gift cards

Most retailers offer gift cards that a customer can purchase and redeem in exchange for goods from the retailer. Existing US GAAP revenue recognition guidance does not specifically address the accounting for gift cards.

Initial accounting upon issuance

Under current practice, retailers defer revenue at the time they sell the gift card to the customer and recognize revenue as the gift card is used by the customer to purchase goods.

In applying the proposed revenue recognition model to gift cards, the customer has made a prepayment before the retailer has performed, so the retailer has a performance obligation to provide goods to the customer in exchange for the gift card at (and after) the time of sale of the gift card to the customer. Consistent with current practice, the retailer would recognize a contract liability for its unfulfilled performance obligation to the customer (i.e., the retailer would defer revenue recognition when it sells the gift card).

Subsequent accounting

Under the proposed model, the retailer would derecognize its contract liability (recognize revenue) as it satisfies its performance obligation to the customer (i.e., as the customer redeems the gift card to purchase goods from the retailer). This would mean that the retailer would recognize revenue equal to the amount of the gift card redeemed by the customer, which is consistent with current practice.

Accounting for "breakage"

The proposed model acknowledges that customers may not exercise all of their contractual rights to receive goods or services and addresses the accounting for these unexercised rights, called "breakage."

Under the proposed model, if a retailer is reasonably assured of a gift card breakage amount, it would recognize expected breakage as revenue in proportion to the redemption of gift cards by customers. If not, the retailer would recognize breakage as revenue when the redemption of the remaining balance becomes remote.

The ED contains specific guidance on the accounting for breakage.

There is currently no authoritative guidance under US GAAP to account for breakage. Today, the primary methods that exist in practice for how a retailer will estimate and recognize gift card breakage revenue are as follows:

- ▶ Redemption recognition method: Estimate and recognize breakage as the gift cards are used for the purchase of goods
- ▶ Delayed recognition method: Estimate and recognize breakage when it is deemed remote that the unused gift card balance will be redeemed

How we see it

Although authoritative guidance for breakage does not exist under current US GAAP, the accounting for breakage under the proposed model appears to be consistent with the two primary methods currently used in practice.

Illustration 7 - 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, company-specific historical evidence to be reasonably assured that 4% of gift card balances will never be redeemed by the customer.

At the point of sale of the gift card to the customer, GTL would record the following journal entry:

Dr. Cash	75	
Cr. Gift card liability		75
<i>To record contract liability for gift card</i>		

One week later, the customer returns to the store and uses the gift card to purchase \$48 worth of goods. GTL would record the following journal entry:

Dr. Gift card liability	48	
Cr. Revenue		48
<i>To record revenue upon gift card redemption</i>		

Additionally, GTL would recognize estimated breakage revenue of \$2 at the time of the redemption, calculated as follows:

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

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

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

Dr. Gift card liability	2	
Cr. Revenue		2
<i>To record revenue for estimated gift card breakage</i>		

GTL would continue to recognize breakage revenue 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 would recognize revenue for the remaining amount.

Other considerations

In addition to the areas noted above, retail and consumer products companies may need to think through some other considerations in evaluating the effects of the proposed revenue recognition model, including the following:

- ▶ How significant are bad debts to the consumer products company?
 - ▶ As discussed in our general Technical Line, the proposed guidance on collectibility represents a significant change from current practice and no longer affects the recognition of revenue. Under the proposed model, estimates of uncollectible amounts would be presented as a separate line item adjacent to the revenue line, as opposed to the typical presentation in selling, general and administrative (SG&A) expense under current US GAAP.

For consumer products companies, particularly those with material bad debts, the effect of implementing the proposed guidance could be a noticeable reduction in gross margins.

- ▶ What shipping terms does the consumer products company or retailer offer?
 - ▶ The ED includes an example in which an entity sells products to a customer, with shipping terms that are FOB shipping point, but for which the entity has established a business practice of providing the customer with a replacement product, at no additional cost, if a product is damaged or lost during shipment. In this example, the ED noted that this business practice may create an enforceable obligation (i.e., risk coverage so that the customer will receive a damage-free product) such that the entity has not satisfied all of its performance obligations at the point of shipment, and therefore would need to defer some portion of the revenue at the time of shipment to the customer. In contrast, under current practice, some entities have concluded that this type of arrangement is effectively a synthetic FOB destination shipping policy, and they defer all revenue until the customer receives the shipment.

It is not entirely clear in the ED how an entity would estimate the selling price of its obligation to cover the risk of loss during shipment and allocate a portion of the transaction price to this performance obligation. We believe one possible method would be to use a cost plus margin approach, applying an appropriate margin to the cost of the items estimated to be lost or damaged during shipment, to arrive at an allocated portion of the total transaction price. Other reasonable methods also might be acceptable.

- ▶ Does the retailer offer a loyalty/rewards program to customers?
 - ▶ Some retailers offer various types of loyalty or rewards programs that provide customers with incentives for continuing to shop with the retailer. These programs may take many different forms, but generally allow the customers to accumulate points or other credits that can be redeemed for free products. Current practice under US GAAP applies one of two potential accounting alternatives: a cost deferral method or a revenue deferral method. The ED concludes that these loyalty programs create a separate performance obligation for the retailer because the programs create a material right that customers would not receive without entering into a contract.

Retailers that operate loyalty or rewards programs or similar offerings will need to evaluate their current accounting to determine whether it is consistent with that in the proposed guidance, which requires an allocation of the transaction price to the loyalty program performance obligation, thus resulting in a deferral of revenue. Additionally, the breakage guidance in the ED discussed above for gift cards also would apply to loyalty and rewards programs.

- ▶ How does the retailer currently present sales taxes collected from customers?
 - ▶ Under current US GAAP, an entity makes an accounting policy election to present sales taxes (or other taxes collected from customers and remitted to governmental authorities) either on a gross basis (included in revenues and cost of goods sold) or on a net basis (excluded from revenues). Under the proposed revenue recognition model, the transaction price is defined as excluding amounts collected on behalf of third parties, including sales taxes. This means that retailers that currently elect to present sales taxes collected from customers on a gross basis would need to begin presenting revenues net of sales taxes collected under the proposed model, reducing top-line revenue.

Next steps

- ▶ Retail and consumer products companies should consider applying the revenue recognition model proposed in the ED to their current (or planned) revenue transactions to identify any potential issues with implementing the proposed guidance.
- ▶ Comments on the ED are due by 13 March 2012.

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