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IFRS industry insights

IASB issues revised exposure draft on revenue recognition – insights for the consumer business industry

The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and redeliberations on the proposals in the original ED issued in June 2010.

On 14 November 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly issued a re-exposure draft ED/2011/6 *Revenue from Contracts with Customers* ('the revised ED'). The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and redeliberations on the proposals in the original ED issued in June 2010. Although the underlying conceptual basis is unchanged, the IASB and the FASB (collectively 'the Boards') changed many detailed aspects of the original ED's proposals. As a result of these changes and the importance of the revenue line item to users of financial statements, the Boards decided to expose for public comment a revised ED. The comment period ends on 13 March 2012. The effective date of the proposed standard will not be earlier than for annual reporting periods beginning on or after 1 January 2015, with the IASB permitting early application.

This IFRS Industry Insight publication highlights aspects of the revised ED that may affect consumer business entities and provides insight to assist in the assessment of the potential impact of these revised proposals.

Customer incentives

Consumer business entities may offer a variety of vendor allowances (e.g., slotting fees and product placement) and customer incentives (e.g., rebates, coupons, buy one get one free products, customer award credits or points, contract renewal options, discounts on future goods and services and price matching). Some of these incentives may include options to acquire additional goods or services.

If these options provide a material right to the customer that it would not receive without entering into that contract (i.e., an incremental right), then the revised ED proposes that these options would give rise to separate performance obligations. In essence, the customer is paying the entity in advance for future goods or services and the entity recognises revenue when those future goods or services are transferred or when the option rights expire.

Consumer business entities that provide incentives (i.e., options) that are considered separate performance obligations will need to allocate the transaction price to each performance obligation (including options) on a relative stand-alone selling price basis. Where the relative stand-alone selling price for the option is not directly observable, the entity should estimate it and the estimate should reflect the discount the customer would obtain when exercising the option, adjusted for:

- any discount that the customer could receive without exercising the option; and
- the likelihood that the option will be exercised.

The revised proposals note that, as a practical alternative, an entity may allocate the transaction price to the optional future goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration where such goods and services are similar to the original goods or services in the contract (e.g., contract renewal options).

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Consumer business entities would need to assess carefully the impact of customer incentives (if they constitute a material right) on their analysis of performance obligations in a contract because the identification of performance obligations and subsequent allocation of the transaction price may affect the timing of revenue recognition and how much revenue is recognised.

Example

A retailer enters into a contract for the sale of equipment for CU1,000. As part of the contract, the retailer provides that particular consumer with a 50 per cent discount coupon for the future purchase of a second identical product in the following month. The retailer placed advertisements in the local newspapers, offering free 10 per cent discount vouchers on future purchases in the following month as part of its seasonal promotion, Hence, the discount that is incremental (40 per cent) would be considered a material right. The retailer would account for the incremental discount as a separate performance obligation in the contract for the sale of equipment. To allocate a portion of the transaction price to the separate performance obligation for the discount coupon, the retailer estimates the probability of redemption to be 70 per cent. As such, the retailer's estimated stand-alone selling price of the discount coupon is CU280 (70% likelihood of exercising the option x CU1,000 selling price x 40% incremental discount). The retailer will allocate CU218.75 (CU1,000 x [CU280/(CU280+CU1,000]) of the CU1,000 transaction price to the discount coupon. Assuming that control has transferred upon the sale of the equipment, the retailer will recognise revenue of CU781.25 and defer recognition of the discount coupon of CU218.75 until the coupon expires or is redeemed.

Sales with a right of return

It is common for consumer business entities to transfer control of products to consumers along with rights to return the products for a variety of reasons. If customers return their purchases, they may be entitled to a refund, store credit or exchange. The revised ED proposes that the entity should account for the transfer of products with a right of return by recognising:

- revenue for the transferred products in the amount of consideration to which the entity is reasonably assured to be entitled (taking into consideration the products that are expected to be returned);
- a refund liability; and
- an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

This is similar to existing guidance. Exchanges by consumers for like for like products are not considered returns and returns of defective products are assessed under the warranty requirements under the revised proposals.

Example

An entity sells 60 television sets for CU200 each. The cost of each television set is CU100 and the entity's customary business practice is to allow a customer to return the product within 60 days and receive a full refund. To determine the transaction price, the entity decides that the approach that is the most predictive of the amount of consideration to which the entity will be entitled will be to use the most likely amount. Using the most likely amount, the entity estimates that 5% of the products will be returned. The entity's experience is predictive of the amount of consideration to which the entity will be entitled. The entity estimates that the costs of recovering the television sets will be immaterial and expects that the returned television sets could be resold at a profit.

At the point of sale, the entity would recognise revenue of CU11,400 [CU200 x 57, based on an expectation that three (60 x 5%) television sets will be returned] and cost of sales of CU5,700 [CU100 x 57 television sets]. A liability for CU600 (5% of the sale price, or CU200 x 3 television sets) is established for the refund obligation and an asset of CU300 (5% of product cost, or CU100 x 3 television sets) is recognised for the entity's right to recover the television sets from customers on settling the refund liability. The probability of return is evaluated at each subsequent reporting date and any changes in estimates are adjusted to the asset and liability with corresponding adjustments to revenue and cost of sales.

Recognising revenue as performance obligations are satisfied

The original ED introduced the concept of 'control' in the determination of when a good or service transfers to a customer and, thus, when revenue is recognised, which may be at a point in time (e.g., delivering a good) or continually over a period (e.g., rendering a service). The original ED provided specific indicators for analysing the transfer of control at a point in time and specified that control may be transferred continuously. Following comments on the original ED, the Boards decided to modify the proposed indicators of when a customer obtains control at a point in time and provide additional guidance that an entity must consider in determining whether control transfers continuously over time (including clarifying how an entity should measure its progress towards completion of a performance obligation that is continuously satisfied).

The revised ED imposes a constraint on the cumulative amount of revenue recognised, being that this should not exceed the amount to which the entity is reasonably assured to be entitled.

The revised ED carries forward most of the proposed guidance in the original ED but describes the concept of control instead of specifically defining it, removes the indicator of control that states that the design or function of the good or service is customer-specific and adds 'risks and rewards of ownership' as an indicator of control. Indicators that the customer has obtained control of the good or service include:

- The entity has a present right to payment for the asset.
- The customer has been transferred legal title to the asset.
- The entity has transferred physical possession of the asset.
- The customer has significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

Sell-through arrangements

Some entities in the consumer business industry use a sell-through arrangement where they deliver products to another party (e.g., dealer or distributor) for sale to the end customer. Under current guidance, revenue is typically only recognised when the products are sold to the end customer (as the risks and rewards of ownership may not be transferred until this point if the consumer business entity has the ability to recall or transfer unsold products).

Under the proposals of the revised ED, entities will need to assess the terms of their sell-through arrangements to determine when control of the products has transferred. If the dealers or distributors have control of the products, including a right of return at their discretion, control transfers when the products are delivered to them. Entities that currently base their revenue recognition policy solely on a transfer of risks and rewards criteria may be affected. Although the transfer of risks and rewards is one indicator of whether control has transferred, the revised proposals include additional criteria that need to be considered. For example, if the entity is able to require the dealer or distributor to return the product, or the dealer or distributor does not have an unconditional obligation to pay for the products, then control has not transferred to the dealer or distributor. As such, revenue would only be recognised when the products are sold to a third party.

Example

A consumer business entity has a one year contract with a dealer to supply products that will be sold to end customers. The entity has the right to sell unsold product to another dealer. The entity has no further obligations and the dealer has no further return rights after the product is sold to the end customer. As the dealer does not have to pay the entity until there is a sale to the consumer and the entity has the right to sell any unsold product to another dealer, control has not transferred. As such, revenue would only be recognised once the product is sold to the end customer.

Licences and Royalties

Some consumer business entities may grant licences to manufacturing entities to produce products using their intellectual property (e.g., a brand name). If an entity grants a licence to a customer, the promised right gives rise to a performance obligation that the entity satisfies when the customer obtains control and can use and benefit from the right.

The revised ED imposes a constraint on the cumulative amount of revenue recognised, being that this should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

- the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and
- the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

Notwithstanding the requirements above, the revised ED notes that if an entity licenses intellectual property to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (e.g., a sales-based royalty), the entity would not be reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (i.e. when the customer's subsequent sales occur).

The proposed accounting for warranties is similar to current practice but consumer business entities would need to consider carefully whether other services are provided in addition to a warranty.

Example

An entity enters into a licence agreement with a customer for five years. Under the agreement, the customer agrees to pay CU1 for each product it manufactures and sells using the entity's intellectual property. The customer will provide this data to the entity at the end of each quarter. After transferring the licence to the customer, the entity does not have any remaining performance obligations.

The cumulative amount of revenue recognised by the entity during the year is limited to the quarterly sales or usage based royalties because the entity would not be reasonably assured to be entitled to the sales or usage based royalties until the uncertainty is resolved, which is as sales occur. Although the entity may have experience with similar contracts, the ED states that, in respect of royalties from licensing intellectual property, amounts are not reasonably assured until the customer's subsequent sales occur.

Breakage

Many entities in the consumer business industry provide customers the right to make a non-refundable prepayment to the entity for the right to receive future goods or services, obliging the entity to stand ready to transfer a good or service. Examples of these types of transactions include gift cards, gift certificates and layaway deposits. The original ED did not provide specific guidance on breakage (unexercised rights e.g., non-use of gift cards). The revised ED proposes that if an entity can be reasonably assured of breakage, then the entity should recognise the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity would recognise the effects of the expected breakage when the likelihood of the customer exercising its remaining rights becomes remote.

This proposed accounting for breakage is generally consistent with existing practice, including in IFRIC 13 *Customer Loyalty Programmes*. A retailer would need to have sufficient historical information that is predictive to estimate the timing and amount of breakage to recognise the effects of expected breakage over time.

Example

An entity sells a CU100 gift card that expires in two years and is reasonably assured on the basis of predictive historical experience with similar gift cards that the amount of breakage is 10% or CU10. A customer purchases a product for CU45 and uses its gift card. The entity would recognise revenue of CU50 (revenue from transferring the product of CU45 plus breakage of CU5 [CU10 x 45/ (100-10)]). If the entity was not reasonably assured of the timing and amount of breakage on its gift cards, the entity would only recognise revenue for breakage when the probability that the gift card will be redeemed becomes remote.

Warranties

Many consumer business entities offer warranties along with the products and services that they provide. The revised ED proposes the following:

- if a customer has the option to purchase a warranty separately from the entity, the entity should account for the warranty as a separate performance obligation. Hence, the entity would allocate revenue to the warranty service; and

- if a customer does not have the option to purchase a warranty separately from the entity, the entity would account for the warranty as a cost accrual unless the warranty provides a service to the customer in addition to assurance that the product complies with agreed-upon specifications (in which case the entity would account for the warranty service as a separate performance obligation).

The revised proposals indicate that when determining whether the exception in the second criterion (other services) applies, the entity would consider whether the entity is required by law to provide a warranty, the length of the warranty coverage period and the nature of the tasks that the entity promises to perform. The proposed accounting for warranties is similar to current practice but consumer business entities would need to consider carefully whether other services are provided in addition to a warranty.

… the retailer needs to assess whether the elements within the warranty should be accounted for as separate performance obligations.

Example

A retailer sells a product, which includes a warranty covering a one year standard warranty required by law as well as a one year extended warranty. To account for the warranty, the retailer needs to assess whether the elements within the warranty should be accounted for as separate performance obligations. As the standard one year warranty does not provide an additional service, the retailer should account for this element as a cost accrual. As the extended warranty is a separate service (which could be purchased separately) to the customer in addition to assurance that the retailer will replace defective components of the product under the standard warranty, the retailer should account for this element as a separate performance obligation. As such, the retailer would need to allocate the transaction price between the product, and the extended warranty. Revenue allocated to the extended warranty would be recognised over the extended warranty period (i.e., from day 1 of year 2 following the first year).

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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