New revenue guidance
Implementation in the consumer markets industry

At a glance

Public companies must adopt the new revenue guidance in 2018. Almost all companies will be affected to some extent by the new guidance, though the effect will vary depending on industry and current accounting practices. Although originally issued as a converged standard, the FASB and IASB have made slightly different amendments so the ultimate application of the guidance could differ under US GAAP and IFRS.

The Revenue Recognition Transition Resource Group (TRG) has discussed various implementation issues impacting companies across many industries. These discussions may provide helpful insight into application of the guidance. The SEC expects registrants to consider these discussions in applying the new guidance.

This publication reflects the implementation developments over the past two years and highlights certain challenges specific to entities in the consumer markets industry. The content in this publication should be considered together with our Revenue guide, available at CFOdirect.com.

Overview

Historically, the accounting for revenue in the consumer markets sector has been governed by multiple pieces of literature under US GAAP and by a single revenue standard and its related interpretations under IFRS. The new revenue standards (ASC 606 and IFRS 15, Revenue from Contracts with Customers) will replace substantially all existing revenue guidance under US GAAP and IFRS. The new standards introduce a new model for revenue recognition, and while it may not broadly change all aspects of the consumer markets industry, certain areas will be significantly affected. This is especially the case for US GAAP preparers, where, for example, certain aspects of transactions that involve customer incentives and loyalty programs will be affected.

Arrangements in the consumer markets sector are often unique to the parties to a transaction and the specific facts and circumstances should be evaluated closely when applying the new standards. Consumer product manufacturing companies may have contracts that govern the manufacturing of products that have no alternative use (e.g., special orders or private labels) for which there is a right to payment. For such arrangements, refer to our industrial products industry supplement for additional guidance.
1. **Identify the contract with the customer**

A contract can be written, oral, or implied by a company’s customary business practices. Generally, any agreement with a customer that creates legally-enforceable rights and obligations meets the definition of a contract. Legal enforceability depends on the interpretation of the law and could vary across legal jurisdictions where the rights of the parties are not enforced in the same way.

Consumer markets companies should consider any history of entering into amendments or side agreements to a contract that either change the terms of, or add to, the rights and obligations of the parties to a contract. These can be verbal or written, and could include cancellation, termination or other provisions. They could also provide customers with options or discounts, or change the substance of the arrangement. All of these have implications for revenue recognition. Therefore, understanding the entire contract, including any amendments, is important to the accounting conclusion.

As part of identifying the contract, companies are required to assess whether collection of the consideration is probable, which is generally interpreted as 75-80% likelihood in US GAAP and a greater than 50% likelihood in IFRS. This assessment is made after considering any price concessions expected to be provided to the customer. In other words, price concessions are variable consideration (which affects the transaction price), rather than a factor to consider in assessing collectibility (see further discussion in Step 3 – Determine the transaction price below). Further, the FASB clarified in an amendment to ASC 606 that companies should consider, as part of the collectibility assessment, their ability to mitigate their exposure to credit risk, for example by ceasing to provide goods or services in the event of nonpayment. The IASB did not amend IFRS 15 on this point, but did include additional discussion regarding credit risk in the Basis for Conclusions to IFRS 15.

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<td>A company accounts for a contract with a customer when:</td>
<td>A company is generally prohibited from recognizing revenue from an arrangement until persuasive evidence of it exists, even if the other revenue recognition criteria have been met. Revenue is recognized when collectibility is reasonably assured.</td>
<td>A company is required to consider the underlying substance and economics of an arrangement, not merely its legal form. Management must establish that it is probable that economic benefits will flow before revenue can be recognized.</td>
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<td>- The contract has been approved and the parties are committed</td>
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<td>- Each party’s rights are identified</td>
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<td>- Payment terms are defined</td>
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<td>- The contract has commercial substance</td>
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<td>- Collection is probable</td>
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<td>In evaluating whether an amount is collectible, management should consider whether a customer has the ability and intention to pay the promised consideration when it is due. The amount of consideration to which</td>
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The company will be entitled to less than the price stated in the contract if the consideration is variable. For example, the company may offer the customer a price concession. When collectibility of the transaction price is not probable at inception, management should continue to assess the contract each reporting period to determine if collectibility is probable. If collectibility of the transaction price is not probable and the company receives consideration from the customer, it should recognize the consideration received as revenue only when one of the following events has occurred:

- There are no remaining obligations to transfer goods or services to the customer, and substantially all of the consideration has been received and is nonrefundable.
- The contract has been terminated, and the consideration received is nonrefundable.
- The company has transferred control of the goods or services to which the consideration received relates, the company has stopped transferring goods or services to the customer (if applicable) and has no obligation to transfer additional goods or services, and the consideration received is nonrefundable [US GAAP].

The third criterion included in ASC 606 is intended to clarify when revenue should be recognized when it is unclear whether the contract has been terminated.

IFRS 15 does not include the third criterion; however, the Basis for Conclusions indicates that a company could conclude a contract has been terminated when it stops providing goods or services to the customer, and therefore it is unlikely that the treatment under ASC 606 and IFRS 15 will be different.

**Potential impact:**

Today, companies that customarily obtain a written contract from their customers are precluded from recognizing revenue under US GAAP until there is a written and final contract signed by both the company and customer. The assessment of whether a contract with a customer exists under the new revenue guidance is driven less by the form of the arrangement and more by whether an agreement between two parties (either written, oral, or implied) creates legally enforceable rights and obligations between them.

The purpose of the collectibility assessment under the new guidance is to determine whether there is a substantive contract between the company and the customer. This differs from current guidance under both frameworks in which collectibility is a constraint on revenue recognition.

The FASB’s amendment to the collectibility guidance, intended to narrow the population of contracts that fail the collectibility assessment, results in differences between US GAAP and IFRS. Despite the differences in how “probable” is interpreted under US GAAP and IFRS, we expect the collectibility threshold to typically be met under both definitions. As a result, we do not expect a significant difference in the conclusion regarding the existence of a contract between US GAAP and IFRS.

The new guidance eliminates the cash-basis method of revenue recognition that is often applied today if collectibility is not reasonably assured (US GAAP) or probable (IFRS). Under the new standards, any cash received is recognized as a contract liability until either collectibility of the transaction price is probable or one of the criteria for recognition is met. This could result in revenue being recorded later than under current guidance in some situations.
2. Identify performance obligations

Consumer product companies often provide assets or services to retailers to aid in the sell-through of product to end customers, such as training the customer’s sales employees, deploying their own employees to work on-site at the customer’s retail location, providing gifts to be included with end customer purchases, and constructing assets at a customer’s location (e.g., “shop-in-shop” or concession areas). There is currently some diversity in practice in the accounting for such assets or services. Under the new standards, these provisions may result in additional performance obligations, which can affect the timing of revenue recognition.

### New guidance

**Performance obligations**

The revenue standards require companies to identify all promised goods or services in a contract and determine whether to account for each promised good or service as a separate performance obligation.

A performance obligation is a promise in a contract to transfer a distinct good or service to a customer.

A good or service is distinct and is separated from other obligations in the contract if both:

- the customer can benefit from the good or service separately or together with other resources that are readily available to the customer; and
- the good or service is separately identifiable from the other goods or services in the contract.

US GAAP states that an entity is not required to separately account for promised goods or services that are immaterial in the context of the contract. IFRS does not include the same specific guidance; however, IFRS companies should consider the application of materiality concepts when identifying performance obligations.

### Current US GAAP

The following criteria are considered to determine whether elements included in a multiple-element arrangement are accounted for separately:

- The delivered item has value to the customer on a standalone basis.
- If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

### Current IFRS

The revenue recognition criteria are usually applied separately to each transaction. In certain circumstances, it might be necessary to separate a transaction into identifiable components to reflect the substance of the transaction.

Two or more transactions might need to be grouped together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.
Options to acquire additional goods or services

An entity may grant a customer the option to acquire additional goods or services free of charge or at a discount. These options may include customer award credits or other sales incentives and discounts, such as a volume discount, that will give rise to a separate performance obligation if the option provides a material right that the customer would not receive without entering into the contract. The company should recognize revenue allocated to the option when the option expires or when the additional goods or services are transferred to the customer.

An option to acquire an additional good or service at a price that is within the range of prices typically charged for those goods or services does not provide a material right, even if the option can be exercised only because of entering into the previous contract.

Potential impact:

Companies will need to identify the different performance obligations in each agreement and pinpoint when and how those obligations are fulfilled. Retailers often offer customers a right to purchase free or discounted goods or services in the future in connection with the sale of goods (e.g., coupons toward additional purchases). These arrangements typically create additional performance obligations.

Consumer product companies will need to closely examine their contracts with customers to evaluate the promises in those arrangements, both verbal and implied, to determine if any meet the definition of a performance obligation. If a service provided by a consumer product company to its customer is determined to be a performance obligation, the costs of fulfilling that service should be presented as cost of sales. Examples of promises that might warrant evaluation include training the customer’s sales employees, deploying employees to work on-site at the customer’s store location, and providing free or significantly discounted product to be provided with end customer purchases.

The accounting for the construction of assets in a customer’s establishment (e.g., sales counters, permanent displays, “shop in shop” arrangements), should be carefully evaluated. First, the consumer product company should determine who legally owns the asset and whether control of the asset transfers to the customer. The evaluation may lead to the conclusion that there is a lease.

If control of the asset does not transfer to the customer, the company should consider whether the construction costs should be accounted for in accordance with other standards (e.g., fixed assets) or as costs to fulfill a contract under the new revenue standards. Any reimbursements received from the customer related to the constructed assets may be part of the transaction price of the underlying product sold to the customer and accounted for in accordance with the guidance on nonrefundable upfront fees in the new revenue standard.

If control of the asset transfers to the customer, the company will need to consider whether there is a separate performance obligation. In situations when the consumer product company contributes to the cost of in-store assets that it does not own via a cash payment to the customer, such payments should be evaluated under the guidance addressing consideration payable to a customer in the new revenue standard.

Payments between the company and its customer related to the construction of assets require careful consideration.
**Gift cards**

The use of gift certificates and gift cards is common in the retail industry. The gift cards or certificates are typically sold for cash and may be used by customers to obtain products or services in the future up to a specified monetary value. The amount of gift certificates that are forfeited is commonly referred to as breakage. Breakage will typically result in the recognition of income for a retailer; however, the timing of recognition depends on expected customer behavior and the legal restrictions in the relevant jurisdiction.

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| When a customer purchases a gift card, it is pre-paying for goods or services to be delivered in the future. The vendor has an obligation to transfer, or stand ready to transfer, the goods or services in the future – creating a performance obligation. The vendor should recognize a contract liability for the amount of the prepayment and derecognize the liability (and recognize revenue) when it fulfills the performance obligation. Expected breakage (i.e., the customer’s unexercised right) should be estimated and recognized as revenue in proportion to the pattern of rights exercised by the customer. The guidance for variable consideration is followed when estimating breakage. If the company is unable to estimate the breakage amount, revenue for the unused portion of the gift card is recognized when the likelihood of the customer exercising its remaining rights becomes remote. If a company is required to remit consideration associated with a customer’s unclaimed rights to a third-party, such as a government body responsible for unclaimed property, the company should not recognize revenue related to unexercised rights. | When the gift card is sold to the customer, a liability is recognized for the future obligation of the retailer to honor the gift card. The liability is relieved (and revenue recognized) when the gift card is redeemed. Currently, three accounting models are generally accepted for the recognition of breakage, depending on the features of the program, legal requirements, and the vendor’s ability to reliably estimate breakage:  
- proportional model - recognize as redemptions occur  
- liability model - recognize when the right expires  
- remote model - recognize when it becomes remote that the holder of the rights will demand performance  
Where escheat laws apply, the vendor cannot recognize breakage revenue for escheatable funds since it is required to remit the funds to a third party even if the customer never demands performance. | Payment received in advance of future performance is recognized as revenue only when the future performance to which it relates occurs. That is, revenue from the sale of a gift card or voucher is accounted for when the seller supplies the goods or services upon exercise of the gift card. No specific models are provided for recognizing breakage. The models used under US GAAP are acceptable under IFRS. |

**Potential impact:**

Similar to today’s accounting models, companies will continue to recognize a contract liability for the obligation to deliver goods and services. Expected breakage should be estimated and recognized as revenue in proportion to the pattern of rights exercised by the customer. If the company does not expect to be entitled to a breakage amount, it will recognize breakage revenue when the likelihood of exercise becomes remote.

Retailers must continue to consider escheat laws. If a retailer is currently not recognizing any breakage revenue because of local escheat laws, then the retailer would not recognize breakage revenue under the new standard.

**Example 2-1 - Gift cards/breakage**

**Facts:** A customer buys a $100 gift card from a retailer, which can be used for up to one year from the date of purchase. Using the guidance for variable consideration and its history of issuing gift cards, the retailer estimates that the customer will redeem $90 of the gift card and that $10 will expire unused (10% breakage). The company has no requirement to remit any unused funds to the customer or any third party when the gift card expires unused. A contract liability of $100 is recorded upon sale of the gift card.
How is revenue recognized when the gift card is redeemed?

**Analysis:** For every $1 of gift card redemptions, the retailer would recognize $1.11 ($1.00 x $100/$90) of revenue with $0.11 of the revenue reflecting breakage. For example, if the customer purchases a $50 product using the gift card, the retailer would recognize $55 of revenue, reflecting the product's selling price and the estimated breakage of $5.

3. **Determine transaction price**

Consumer markets companies offer a wide array of customer incentives. Retailers commonly offer coupons, rebates issued at the point of sale, free products ("buy-one-get-one-free"), price protection, or price matching programs to their customers. Consumer product companies commonly provide vendor allowances, including volume rebates and cooperative advertising allowances, mark-down allowances (compensation for poor sales levels of vendor merchandise), and volume discounts to their customers. Various pieces of guidance apply today and there is some diversity in practice in accounting for such incentives.

Customer incentives can affect the amount and timing of revenue recognition in several ways. They can create additional performance obligations, which can affect the timing of revenue recognition, and they often introduce variability into the transaction price, which can affect the amount of revenue recognized. The new revenue standards include specific guidance addressing these areas. The guidance for variable consideration in particular will apply to a wide range of customer incentives and is different from the existing guidance under IFRS and US GAAP.

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<td><strong>Consideration payable to a customer</strong></td>
<td>A company needs to determine the transaction price, which is the amount of consideration it expects to be entitled to in exchange for transferring promised goods or services to a customer. Consideration payable by a company to a customer is accounted for as a reduction of the transaction price unless the payment is for a distinct good or service that the customer transfers to the company and the payment does not exceed fair value of that good or service.</td>
<td>Sales incentives offered to customers are typically recorded as a reduction of revenue at the later of the date at which the related sale is recorded by the vendor or the date at which the sales incentive is offered. Volume rebates are recognized as each of the revenue transactions that results in progress by the customer toward earning the rebate occurs.</td>
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<td><strong>Variable consideration</strong></td>
<td>The transaction price might include an element of consideration that is variable or contingent on the outcome of future events, including (but not limited to) discounts, rebates, price concessions, refunds, returns, credits, incentives, performance bonuses and royalties.</td>
<td>Sales incentives offered to customers are recorded as a reduction of revenue at the time of sale. Management uses its best estimate of incentives expected to be awarded to estimate the sales price. The potential impact of volume discounts is considered at the time of the original sale. Revenue from contracts that provide customers with volume discounts is measured by reference to the estimated volume of sales and the expected discounts. Revenue should not exceed the amount of consideration that would be received if the maximum discounts were taken if management cannot reliably estimate the expected discounts.</td>
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<td>Variable consideration is estimated using either an expected value or most likely outcome method, whichever provides the best estimate.</td>
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<td>Variable consideration is included in the transaction price to the extent it is probable (US GAAP) or highly probable (IFRS) that there will not be a significant reversal in the amount of cumulative revenue recognized when the uncertainty is resolved. Although the terminology differs, the threshold of probable under US GAAP and highly probable under IFRS are generally interpreted to have the same meaning.</td>
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<td>Judgment will often be needed to determine whether it is probable or highly probable there will not be a significant reversal in the amount of cumulative revenue. The revenue standards provide indicators that might suggest such a reversal would take place.</td>
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**Potential impact:**

Companies that defer revenue recognition under current guidance because the price is not fixed or determinable (US GAAP) or reliably measurable (IFRS) might be significantly affected by the revenue standards. In a situation when the price is fixed, but the company has a history of granting concessions, companies would be required to recognize the minimum amount of revenue they expect to be entitled to when control transfers as long as it is probable (US GAAP) or highly probable (IFRS) that there will not be a significant reversal of cumulative revenue recognized when the uncertainty is resolved.

The evaluation of variable consideration will require judgment in many cases. Some companies will need to recognize revenue before all contingencies are resolved, which might be earlier than under current practice. Management might need to put into place new processes to monitor estimates on an ongoing basis as more experience is obtained.

Though prospective volume discounts and volume rebates may offer customers similar economic incentives, the accounting and disclosure requirements under the new standards will be different due to different guidance for material rights (prospective volume discounts) and variable consideration (volume rebates).

- **Volume rebates** are a sales incentive program under which the entity makes a cash payment to its customer once the customer reaches a specified cumulative level of purchases.

- **Prospective volume discounts** are a sales incentive program that provides the customer with an option for free or discounted goods or services in the future.

The two incentive programs differ because volume rebates are not an option to purchase future free or discounted goods or services, and therefore not considered to be material rights. Under the new standards, the promise of a cash rebate affects the estimate of transaction price. The cash rebates expected to be paid to a customer are variable consideration as they would reduce the amount the customer pays, and should be estimated at contract inception to determine the transaction price. In comparison, volume discount arrangements that include a material right affect the timing of revenue recognition as revenue is allocated to the performance obligation (i.e., the right) and recognized when the free or discounted goods or services are provided or when the right expires.

When a consumer product entity accounts for consideration payable to a customer as a reduction to the transaction price, a liability will be recorded on the balance sheet until the related payments to the customer are made. Generally, this liability will not meet the definition of a contract liability because it does not obligate the company to transfer future goods or services to the customer. Therefore, the liability should be presented separate from any contract liabilities and would not be subject to the new disclosure requirements for contract balances.

**Example 3-1 – Retailer-issued coupons**

**Facts:** A retailer sells goods to a customer for $100,000 and at the same time provides a coupon for a 60% discount off a future purchase during the next 90 days. The retailer intends to offer a 10% discount on all sales as part of a promotional campaign during the same period. Management estimates that 75% of customers that receive the coupon will exercise the option for the purchase of, on average, $40,000 of discounted additional product.

How should the retailer account for the option provided by the coupon?
A company should generally assume 100% redemption of the options if it does not have sufficient history to estimate the extent of redemption.

**Example 3-2 – Manufacturer-issued coupons**

**Facts:** A manufacturer sells 1,000 boxes of laundry detergent to a retailer for $10 per box. Control transfers when the product is delivered to the retailer. There are no return, price protection, stock rotation, or similar rights. The retailer sells the laundry detergent to end customers for $12 per box. The manufacturer simultaneously issues coupons directly to end customers via newspapers, which are valid for the next six months and provide a $1 discount on each box of detergent purchased. The coupons are presented by the end customer to the retailer upon purchase of the detergent. The retailer submits coupons to the manufacturer and is compensated for the face value of the coupons ($1). Using the expected value method (which the manufacturer believes is most predictive of the consideration it will be entitled to), the manufacturer estimated that 400 coupons will be redeemed. The manufacturer has recent experience with similar promotions involving similar pricing and discounting levels. Therefore, it concludes it is probable (US GAAP) or highly probable (IFRS) that the actual number of coupons redeemed will not result in a significant reversal of the cumulative revenue recognized.

How much revenue should the manufacturer and retailer recognize?

**Analysis:** The manufacturer would recognize $9,600 of revenue ($10,000 less estimated coupon redemptions of $400) for detergent sold to the retailer. While the retailer’s accounting in this scenario is not specifically addressed by the new standards, we generally believe the additional consideration paid by the manufacturer is revenue to the retailer, as the fair value of the total consideration received by the retailer is $12. Following this logic, the retailer would recognize revenue of $12 and cost of sales of $10 for each box upon sale to the end customer, whether or not they present a coupon. Cost of sales would remain as the original amount paid by the retailer to the manufacturer.

**Example 3-3 – Free product rebate**

**Facts:** A vendor is running a promotion whereby an end customer who purchases three boxes of golf balls at $20 per box in a single transaction receives an offer for one free box of golf balls if the customer fills out a request form and mails it to the vendor before a set expiration date (a mail-in rebate). The vendor estimates, based on recent experience with similar promotions, that 80% of the customers will complete the mail-in rebate required to receive the free box of golf balls.

How should the consideration be allocated to the various deliverables in the arrangement?

**Analysis:** The purchase of three boxes of golf balls gives the customer the right to the fourth box for free. This is a material right, which is accounted for as a separate performance obligation. The transaction price would be allocated to the right using relative standalone selling price, which considers estimated redemptions. Therefore, the value of the option would be $16 ($20 x 100% discount x 80% expected redemption). Management would allocate $12.63 ($60 x ($16 / ($16 + $60))) of the transaction price to the mail-in rebate. The vendor would recognize revenue of $47.37 when control of the three boxes of golf balls transfers, and recognize a liability for $12.63 until the rebate is redeemed or expires unredeemed. If the vendor is unable to determine the number of mail-in rebates that will be used, management should assume 100% redemption. Management would allocate $15 ($60 x ($20 / ($20 + $60))) to the undelivered box and recognize revenue on delivery following redemption, expiration of the rebate, or until it is able to make an estimate. As the fourth box is a performance obligation, the cost of the fourth box should be presented as cost of sales.

**Example 3-4 – Slotting fees**

**Facts:** A manufacturer sells products to a retailer for $8 million. The manufacturer also makes a $1 million non-refundable upfront payment to the retailer for favorable product placement.
How should the manufacturer and retailer account for the upfront payment?

**Analysis:** The product placement services cannot be sold separately. The service is not distinct because the manufacturer would not obtain any rights or receive any benefit without selling products to the retailer. The manufacturer should recognize a reduction in the transaction price of $1 million and recognize $7 million in revenue when control of the products transfers to the retailer.

From the retailer’s perspective, the $1 million upfront payment for product placement services is not a payment for satisfying a distinct performance obligation and should be recognized as a reduction of cost of goods sold.

**Example 3-5 – Price protection**

**Facts:** A retailer sells a product to a customer for $100 on January 1 and agrees to reimburse the customer for the difference between the purchase price and any lower price offered by a certain direct competitor during the three-month period following the sale. The retailer has recent experience with similar promotions of similar products. On a probability-weighted basis, the retailer estimates it will reimburse the customer $5.

How should the retailer account for the potential refund?

**Analysis:** The consideration expected to be repaid to the customer should be excluded from revenue and recorded as a liability at the time of sale. Assuming management concludes, based on its recent experience, that it is probable (or highly probable) that recognizing $95 would not result in significant reversal of cumulative revenue upon resolution of the uncertainty, the retailer would recognize revenue of $95 and a refund liability of $5.

Please refer to our industrial products industry supplement for additional discussion and examples related to determining transaction price.

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4. Allocate transaction price

Under the new revenue guidance, the transaction price in an arrangement is allocated to each separate performance obligation based on the relative standalone selling prices of the goods or services being provided to the customer. That allocation may need to be adjusted if variable consideration or discounts apply exclusively to only certain performance obligations.

Loyalty programs should be considered when allocating the transaction price. Retailers often use customer loyalty programs to build brand loyalty and increase sales volume by providing customers with incentives to buy their products. Each time a customer buys goods or services, the retailer grants the customer award credits. The customer can redeem the credits for awards such as free or discounted goods or services. The award credits are a separate performance obligation to which consideration is allocated.

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<td>An option to acquire additional goods or services gives rise to a separate</td>
<td>There is divergence in practice in US GAAP in the accounting for loyalty</td>
<td>Customer loyalty programs are accounted for as multiple-element arrangements. Consideration is</td>
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<td>performance obligation if the option provides a material right that the</td>
<td>programs. Two models commonly followed are an incremental cost accrual model and</td>
<td>allocated to the award credits based on their fair values, typically using the residual method,</td>
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<td>customer would not receive without entering into that contract. The revenue</td>
<td>a multiple-element revenue model. Under the incremental cost model, revenue is</td>
<td>although the guidance also permits relative fair values. This amount is deferred and recognized as</td>
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<td>standards require management to estimate the transaction price to be allocated</td>
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<td>revenue when the award credits are redeemed or expire.</td>
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<td>to the separate performance obligations</td>
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and to recognize a contract liability for the performance obligations that will be satisfied in the future. The customer is paying for the future goods or services to be received when the award credits are issued in conjunction with a current sale. The company recognizes revenue for the option when those future goods or services are transferred to the customer or when the option expires.

The fair value of the award credits is adjusted for discounts available to other buyers absent entering into the initial purchase transaction and for expected forfeitures (breakage).

Potential impact:
The revenue standards are consistent with the multiple-element model currently required under IFRS, but will likely have a greater impact on US GAAP companies. The transaction price is allocated between the product and the loyalty reward performance obligations based on relative standalone selling price. The amount allocated to the loyalty rewards is recognized as a contract liability and revenue is recognized when the rewards are redeemed or expire. This will generally result in later revenue recognition for a portion of the transaction price for those currently using an incremental cost model under US GAAP.

The accounting for loyalty programs is expected to result in additional complexities and disclosure requirements for entities that currently apply the incremental cost model under US GAAP. Companies will need to account for points issued and rights earned under these programs as separate performance obligations, which could involve developing more robust valuation models to enable management to comply with the new revenue standards. Specifically, companies will need to thoroughly consider concepts such as redemption curves, breakage estimates, and the value of the loyalty award.

**Example 4-1 - Loyalty points**

**Facts:** A retailer has a loyalty program that rewards customers one point per $1 spent. Points are redeemable for $0.10 off future purchases (but not redeemable for cash). A customer purchases $1,000 of product at the normal selling price and earns 1,000 points redeemable for $100 off future purchases of goods or services. The retailer expects redemption of 950 points (that is, 5% of points will expire unredeemed). The retailer therefore estimates a standalone selling price for the incentive of $0.095 per point based on the likelihood of redemption ($0.10 less 5%).

How is the consideration allocated between the points and the product?

**Analysis:** The retailer would allocate the transaction price of $1,000 between the product and points based on the relative standalone selling prices of $1,000 for the product and $95 for the loyalty reward as follows:

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<th>Amount</th>
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<tbody>
<tr>
<td>Product</td>
<td>$913 ($1,000 x $1,000/$1,095)</td>
</tr>
<tr>
<td>Points</td>
<td>$ 87 ($1,000 x $95/$1,095)</td>
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</table>

The revenue allocated to the product is recognized upon transfer of control of the product and the revenue allocated to the points is recognized upon the earlier of the redemption or expiration of the points. The estimate of the number of awards that will expire unredeemed is updated at each period end and the contract liability adjusted accordingly.
5. **Determine transfer of control and recognize revenue**

Consumer markets companies distribute their product to customers in a variety of different ways. For certain distribution channels, such as retail point of sale, the timing of revenue recognition is straight-forward and not expected to change. For other distribution channels, consumer markets companies will need to apply judgment when evaluating when control transfers to ultimately determine the timing of revenue recognition, which may be different than under current guidance.

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<th>New guidance</th>
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<tr>
<td>Revenue should be recognized when control of the goods or services is transferred to the customer. A company transfers a good or service when the customer obtains control of that good or service. A customer obtains control of a good or service if it has the ability to direct the use of and receive the benefit from the good or service. Indicators that the customer has obtained control of the good or service include:</td>
<td>Revenue is recognized once the risks and rewards of ownership have transferred to the customer. Goods delivered to a consignee pursuant to a consignment arrangement are not considered sales, and do not qualify for revenue recognition. Once it is determined that substantial risk of loss, rewards of ownership, as well as control of the asset have transferred to the consignee, revenue recognition would then be appropriate, assuming all other criteria for revenue recognition have been satisfied.</td>
<td>A contract for the sale of goods normally gives rise to revenue recognition at the time of delivery, when the following conditions are satisfied:</td>
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<tr>
<td>- The company has a present right to payment for the asset.</td>
<td>- The risks and rewards of ownership have transferred.</td>
<td>- The risks and rewards of ownership have transferred.</td>
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<tr>
<td>- The customer has legal title to the asset.</td>
<td>- The seller does not retain managerial involvement to the extent normally associated with ownership and does not retain effective control.</td>
<td>- The seller does not retain managerial involvement to the extent normally associated with ownership and does not retain effective control.</td>
</tr>
<tr>
<td>- The company transferred physical possession of the asset.</td>
<td>- The amount of revenue can be reliably measured.</td>
<td>- The amount of revenue can be reliably measured.</td>
</tr>
<tr>
<td>- The customer has the significant risk and rewards of ownership.</td>
<td>- It is probable that the economic benefit will flow to the customer.</td>
<td>- It is probable that the economic benefit will flow to the customer.</td>
</tr>
<tr>
<td>- The customer has accepted the asset.</td>
<td>- The costs incurred can be measured reliably.</td>
<td>- The costs incurred can be measured reliably.</td>
</tr>
<tr>
<td>A product is held on consignment if the buyer has physical possession of a good, but has not obtained control. An entity should not recognize revenue for products held by its customers on consignment. Indicators that there is a consignment arrangement include:</td>
<td>Revenue is recognized once the risks and rewards of ownership have transferred to the customer.</td>
<td>Revenue is recognized once the risks and rewards of ownership have transferred to the customer.</td>
</tr>
<tr>
<td>- The product is controlled by the seller until a specified event, such as a sale to an end customer.</td>
<td></td>
<td>Revenue is not recognized on consignment sales until performance has taken place. If the purchaser of goods on consignment has undertaken to sell the items on the seller's behalf, then revenue should not be recognized by the seller until the goods are sold to a third party.</td>
</tr>
</tbody>
</table>

**Potential impact:**

The effect of the revenue standards on consumer markets distribution arrangements will depend on the terms of the contract. The new revenue standards require management to determine when control of the product has transferred to the customer. Revenue is recognized when the customer or distributor has control of the product, even if the terms include a right of return (i.e., not when the product is transferred to the end customer).
New guidance

- The company is able to require the return or transfer of the product to third party.
- The dealer does not have an unconditional obligation to pay for the product.

Current US GAAP

Expected returns or price concessions affect the amount of revenue, but not when revenue is recognized. Revenue could therefore be recognized earlier under the new revenue standards.

The main reason that timing of revenue recognition could change for some companies is because current guidance is focused on the transfer of risks and rewards rather than the transfer of control. The transfer of risks and rewards is an indicator of whether control has transferred under the new revenue standards, but additional indicators will also need to be considered. Control could transfer before all of the risks and rewards transfer.

If the company can require the customer or distributor to return the product (that is, it has a call option), control has not transferred to the customer.

Current IFRS

Example 5-1 - Sale of products to a distributor with a right of return

Facts: A consumer products company uses a distributor network to supply its product to the end customer. The distributor receives legal title and is required to pay for the products upon receipt, but may return unsold product at the end of the contract term. Once the products are sold to the end customer, the consumer products company has no further obligations for the product and the distributor has no further return rights.

When does the consumer products company recognise revenue?

Analysis: Revenue is recognized once control of the product has transferred, which requires an analysis of the indicators of the transfer of control. The distributor has physical possession, legal title, a present obligation to pay for the asset, and the right to determine whether the goods are returned, which are all indicators that control transferred when the goods were delivered to the distributor. As control has transferred to the distributor and revenue is recognized, the consumer products company would recognize a liability for expected returns (discussed in further detail below).

Note: In instances when control transfers to the retailer and revenue is recognized but the consideration the company receives is dependent on the sell-through price to the end customer (or on the extent of any returns), the guidance for variable consideration would be applied to determine the transaction price.

Example 5-2 - Sale of products on consignment

Facts: A manufacturer provides household goods to a retailer on a consignment basis (scan-based trading). The manufacturer retains title to the products until they are scanned at the register. The retailer does not have an obligation to pay the manufacturer until a sale occurs and any unsold products may be returned to the manufacturer. The manufacturer also retains the right to call back or transfer unsold products to another retailer. Once the retailer sells the products to the end customer, the manufacturer has no further obligations for the products, and the retailer has no further return rights.

When does the manufacturer recognise revenue?

Analysis: The manufacturer should recognize revenue when control has passed to the retailer, which requires an analysis of the indicators of the transfer of control. Although the retailer has physical possession of the products, it does not take title or have an unconditional obligation to pay the manufacturer, and the manufacturer maintains a right to call the products. Therefore, control does not transfer and revenue is not recognized until the product is sold to the end customer.

Shipments to customers with a common carrier, including e-Commerce

Consumer product companies often use common carriers to ship products to customers. Retailers also commonly use common carriers to deliver products to their e-Commerce customers. These companies often have a customary practice of replacing or crediting lost or damaged goods even when sales contain "free on board" (FOB) shipping point terms, and the customer obtains control at the time of shipment. In such instances, the customer is in the same position as if the shipping terms were FOB destination. Revenue would likely be recognized when the product is received by the customer under today's guidance because the risks and rewards of ownership have not been substantively transferred to the customer at the point of shipment. Under the new standards, transferring the risks and rewards of ownership is only
one of the five indicators that a customer has obtained control of the asset. Not transferring the risks and rewards of ownership does not automatically preclude revenue recognition under the new standards as it does today. As a result, the timing of revenue recognition for certain contracts might change as consumer markets companies apply the new standards’ control-based model.

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<td>Revenue should be recognized when control of the good or service is transferred to the customer, as described in the section above.</td>
<td>Revenue from the sale of a good should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery.</td>
<td>A contract for the sale of goods normally gives rise to revenue recognition at the time of delivery, as described above.</td>
</tr>
<tr>
<td>Situations when a company transfers control of a good but retains the risk of loss or damage based on shipping terms could indicate that an additional performance obligation to cover any losses exists that has not yet been fulfilled.</td>
<td>The risks and rewards of ownership need to substantively transfer to the customer. All revenue is deferred until the goods have been delivered to the end customer if the vendor has established a practice of covering risk of loss in transit.</td>
<td>Revenue is typically recognized once the goods reach the buyer. This would be the case when there are synthetic FOB destination terms, as risks and rewards of ownership typically transfer at that time.</td>
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</table>
| Additionally, under US GAAP, when a customer obtains control of a good prior to shipment, a company may make a policy election to account for shipping and handling activities as a fulfillment cost rather than as an additional promised service. If elected, a portion of the transaction price will not be allocated to the shipping services and the costs of shipping and handling will be accrued when the related revenue is recognized. This election should be applied consistently to similar transactions and disclosed if material. Such an election is not available under IFRS. | Management will also need to assess whether the shipping terms create additional performance obligations when control transfers on shipment. Examples of this could be shipping and in-transit risk of loss coverage. Control of the underlying goods could be transferred and revenue recognized when the product leaves the seller’s location, based on legal title transfer, the entity’s right to receive payment, or the customer’s ability to redirect and sell the goods, but there might be additional performance obligations for shipping and in-transit risk of loss. Management will need to allocate the transaction price to each of the performance obligations, and recognize revenue when each performance obligation is satisfied, which might be at different times. Management should consider the effect of these arrangements based on the facts and circumstances of each transaction. If a US GAAP reporter makes the policy election to account for shipping and handling activities as a fulfillment cost, management should apply this election consistently to similar transactions and disclose the use of the election, if material. | **Potential impact:**

The timing of revenue recognition could change under the new revenue standards as the transfer of risks and rewards is no longer a requirement for revenue recognition, but an indicator of when control of the goods transfers to the customer. All of the indicators of whether control has transferred would need to be assessed based on facts and circumstances. For example, a good may be shipped under FOB destination terms. However, control may transfer upon shipment if the customer has the ability to sell the good and re-direct delivery to its own customers while in transit. |

**Example 5-3 - Shipments to customers with a common carrier**

**Facts:** An electronics manufacturer enters into a contract to sell flat screen televisions to a retailer. The delivery terms are free on board (FOB) shipping point (legal title passes to the retailer when the televisions are handed over to the carrier). A third-party carrier is used to deliver the televisions. The manufacturer has a past business practice of providing replacements to the retailer, at no additional cost, if the televisions are damaged during transit.

The retailer does not have physical possession of the televisions during transit, but has legal title at shipment and therefore can redirect the televisions to another party. The manufacturer is also precluded from selling the televisions to another customer while in transit.

When does control of the televisions transfer?
**Analysis:** The manufacturer would assess the indicators of transfer of control and recognize revenue when control transfers to the retailer. Though the risks and rewards of ownership have not transferred, the retailer has legal title and can direct the televisions to another party during transit. The manufacturer would likely conclude that control transfers and revenue should be recognized at shipping point. The manufacturer should consider whether additional performance obligations exist relating to in-transit risk of loss coverage based on its past business practice.

**Bill-and-hold arrangements**

Consumer product manufacturing entities may have bill-and-hold arrangements with their customers whereby the companies bill customers for goods, but do not deliver those goods until a later date. Retailers may have similar arrangements whereby customers are offered layaway services. Companies can currently recognize revenue when product is billed (rather than on delivery) if the arrangement meets certain criteria.

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<td>The new revenue standards focus on when control of the goods transfer to the customer to determine when revenue is recognized. A customer may obtain control of a product even though that product remains in the vendor’s physical possession in some circumstances. A customer has control when it has the ability to direct the use of, and obtain the remaining benefits from, the product, even if it does not have physical possession of the product. For a customer to have obtained control of a product in a bill-and-hold arrangement, the following criteria must be met: (1) the reason for the arrangement is substantive, (2) the product has been identified separately as belonging to the customer, (3) the product is ready for delivery in accordance with the terms of the arrangement, and (4) the vendor does not have the ability to use the product or sell the product to another customer.</td>
<td>All of the following criteria must be met to recognize revenue when delivery has not occurred: (1) risks of ownership have passed to the customer, (2) the customer has made a fixed commitment, (3) the arrangement has substantial business purpose, (4) there is a fixed schedule for delivery, (5) there are no other performance obligations of the seller, (6) the product is identified separately as belonging to the customer, and (7) the product is ready for shipment in its present condition.</td>
<td>Revenue is recognized in bill and hold transactions when the buyer takes title, provided (1) it is probable that delivery will be made, (2) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognized, (3) the buyer specifically acknowledges the deferred delivery instructions, and (4) the usual payment terms apply.</td>
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**Potential impact:**

Companies will need to consider the facts and circumstances of their arrangements to determine whether control of the product has transferred to the customer prior to delivery.

The requirement to have a fixed delivery schedule often precludes revenue recognition for bill-and-hold arrangements under current US GAAP; however, this requirement is not included in the new revenue standards, which may result in earlier revenue recognition under the new standards if the company has met the bill-and-hold criteria and all of the other criteria related to the transfer of control.

A company that has transferred control of the goods to recognize revenue needs to consider whether it is providing custodial services in addition to providing the goods and whether those custodial services are a performance obligation. If so, a portion of the transaction price should be allocated to each of the separate performance obligations (that is, the goods and the custodial service).

**Example 5-4 – Bill-and-hold arrangement**

**Facts:** A video game company enters into a contract to supply 100,000 video game consoles to a retailer. The contract contains specific instructions from the retailer about where the consoles should be delivered. The video game company must deliver the consoles in the next year at a date to be specified by the retailer. The retailer expects to have sufficient shelf space at the time of delivery. As of year-end, the video game company has inventory of 120,000 game consoles, including the 100,000 relating to the contract with the retailer. The 100,000 consoles are stored with the other 20,000 game consoles, which are all interchangeable products; however, the video game company will not deplete its inventory below 100,000 units.
When should the video game company recognize revenue for the 100,000 units to be delivered to the retailer?

**Analysis:** The video game company should not recognize revenue until the bill-and-hold criteria are met and control is transferred to the customer. Although the reason for entering into a bill-and-hold transaction is substantive (lack of shelf space), the other criteria are not met as the game consoles produced for the retailer are not separated from other products.

**Intellectual property licenses and franchise agreements**

Licenses are common in the consumer markets sector. Many products include a licensed image or name. Consumer markets entities may license their trade names or grant franchise rights to others. Additionally, these arrangements may also include other obligations, such as ongoing support, additional services, etc. Licenses can include various features and economic characteristics, which can lead to significant differences in the rights provided by a license. The terms might be perpetual or for a defined period of time. Accounting for licenses and franchise rights under the revenue standards may be different compared to today.

A company should first consider the guidance for identifying performance obligations to determine if the license is distinct from other goods or services in the arrangement. For licenses that are not distinct, a company will combine the license with other goods and services in the contract and recognize revenue when it satisfies the combined performance obligation.

There are differences in the new revenue standards for licenses between US GAAP and IFRS. US GAAP requires that intellectual property (IP) be classified as either “functional” or “symbolic,” which impacts the timing of revenue recognition (point in time vs. over time). Under IFRS, whether revenue is recognized at a point in time or over time depends on the nature of a license and whether the company’s activities significantly change the IP. While we expect that the outcome of applying the new revenue standards will be similar under IFRS and US GAAP, there may be fact patterns for which outcomes could differ.

The new revenue standards include an exception relating to variable consideration for the recognition of sales- or usage-based royalties from licenses of IP. Revenue from a sales- or usage-based royalty is not recognized until the later of when (1) the customer’s subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied or partially satisfied. The exception would also apply when a contract includes a royalty, a license of IP and other goods and services, and the license is the “predominant” item to which the royalty relates. However, the exception does not apply to an outright sale of IP.

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<td>When a license is distinct, a company must consider the nature of the license to determine when to recognize revenue. US GAAP defines two categories of licenses to help in this assessment: (1) functional and (2) symbolic.</td>
<td>Consideration is allocated to the license and revenue is recognized when earned and realized or realizable. Revenue is generally earned at either the beginning or throughout the license term, depending upon the nature of the license and any other obligations of the licensor. Royalty revenue is generally recognized when realized or realizable.</td>
<td>Revenue is not recognized under licensing and franchise agreements until performance occurs and the revenue is earned. The assignment of rights for a non-refundable amount under a non-cancellable contract permits the licensee to use those rights freely. When the licensor has no remaining obligations to perform, the assignment is, in substance, a sale. A fixed license term is an indicator that the revenue should be recognized over the period because the fixed term suggests that the license's risks and rewards have not been transferred to the customer. Royalties are recognized on an accrual basis in accordance with the relevant agreement's substance.</td>
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<tr>
<td>Functional IP (US GAAP)</td>
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<td>Functional IP includes software, drug formulas or compounds, and completed media content. A license to functional IP grants a right to use the company's IP as it exists at the point in time at which the license is granted unless both of the following criteria are met:</td>
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<td>• The functionality of the IP is expected to substantively change during the license period as a result of activities of the company</td>
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that do not transfer a promised good or service to the customer.

- The customer is contractually or practically required to use updated IP.

**Symbolic IP (US GAAP)**

Symbolic IP is anything that is not functional IP. Symbolic IP includes brands, logos, team names, and franchise rights. Symbolic IP is a right to access IP because of the entity’s obligation to support or maintain the IP over time.

IFRS does not define symbolic and functional licenses but instead includes guidance to determine whether a license provides a right to access or a right to use its intellectual property.

**Right to use IP**

Licenses that provide a right to use IP are performance obligations satisfied at a point in time.

**Right to access IP**

Licenses that provide a right to access a company’s IP are performance obligations satisfied over time.

The IFRS guidance is based on the extent to which an entity’s activities affect the intellectual property because they either change its form or functionality or because the customer’s ability to benefit from the intellectual property is derived from those activities.

In many cases the IFRS and US GAAP guidance will result in the same conclusion about the nature of a license but differences in limited cases are possible because of differences in the words.

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**Potential impact:**

The new guidance for licenses is different from today’s models, so the timing of revenue recognition might change depending on the model currently followed.

A company should first consider the guidance for distinct performance obligations to determine if the license is distinct from other goods or services in the arrangement. Licenses that are not distinct are combined with other goods and services in the contract to identify a distinct performance obligation. Revenue is recognized when that performance obligation is satisfied. Complex arrangements, which include licenses and other performance obligations, will require careful consideration to determine whether the license should be accounted for separately.

The next step for distinct licenses is to determine the nature of the promise in granting the license, which will determine whether revenue is recognized at a point in time or over time. Licensors may have to perform a much more detailed assessment than previously to determine the nature of the license and when revenue is recognized.

Common licensing scenarios for consumer product manufacturers, such as trademarks and tradenames, will likely meet the definition of symbolic IP under US GAAP, as the IP does not have significant standalone functionality. That is, the utility of the IP is derived from its association with a company’s past and future ongoing activities. Under IFRS, the determination of whether licenses to trademarks and tradenames provide a right to access IP is based on whether the IP is significantly affected by the company’s activities. Most trademark and tradename licenses will also be right of access licenses under IFRS.

Other arrangements, such as the licensing of a patent, product formula, or recipe, will likely be considered functional IP under US GAAP, as the license granted has significant standalone functionality, and as right to use IP under IFRS.

**Franchise accounting:**

Franchise arrangements often involve the right to access intellectual property as well as other goods and services, such as point-of-sale systems, equipment, signage, and layouts. The specific guidance in US GAAP regarding the accounting for franchise agreements has been eliminated. Companies that grant franchise rights to third parties will apply the principles for license agreements described above. Companies should evaluate the different promises (explicit and implicit) within a franchise arrangement to determine whether there are multiple performance obligations. For example, equipment provided upfront may be a separate performance obligation from the licensed franchise right.

It will be important for franchisors to understand the nature of the license being conveyed to franchisees, including a differentiation between area development rights (e.g., the right to potentially open 20 locations in a specific region) and franchise rights (e.g., the right to operate one specific location). Franchise-related rights, including both area development and franchise rights, will generally be considered symbolic licenses of IP as the licensed rights typically do not have significant standalone functionality, which will require recognition of franchise fees (including upfront fees), over the franchisee’s contractual term. Franchisors will need to understand the nature of area development arrangements and the related fees to determine the appropriate revenue attribution.
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<td>Under IFRS, similar guidance will need to be followed; however, the definition of symbolic and functional IP are not included in IFRS 15 and therefore the provisions of the contract will need to be assessed against the criteria in IFRS 15 to determine whether they are right to access or right to use licenses. Franchise arrangements will typically be right to access licenses under IFRS.</td>
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Licenses of IP that involve variable consideration due to sales- or usage-based royalties are subject to specific guidance on revenue recognition. The application of this guidance is not optional. Therefore, companies will need to carefully consider whether their license arrangements fall within this guidance.

Variable consideration from the license of IP that is based on a sales- or usage-based royalty is excluded from the transaction price until the sale or usage occurs. Therefore, because royalties should be recognized in the period the sales or usage occur (assuming the performance obligation has been satisfied), it may be necessary for management to estimate sales or usage that have occurred, but have not yet been reported by the customer. In other words, recognizing royalty revenue on a lag basis is not permitted under the new standards.

Minimum guarantees are common in license arrangements in which the consideration is in the form of a sales-based or usage-based royalty. Questions arise in practice when determining whether and how the minimum guarantee impacts the application of the recognition constraint for sales-based or usage-based royalties for licenses of IP. The FASB’s TRG discussed the issue at a November 2016 meeting. The TRG noted that, for functional IP, a minimum guarantee is fixed consideration and should be recognized when the licensor transfers control of the IP to the licensee. The variable consideration (i.e., the amount above the fixed minimum) should be recognized in accordance with the sales- or usage-based royalty exception.

For licenses in which revenue is recognized over time (i.e., symbolic IP), the TRG discussed three acceptable approaches to the sales-based or usage-based exception for licenses of symbolic IP that include a minimum guarantee:

- Recognize revenue as the royalties occur if the licensor expects the total royalties to exceed the minimum guarantee.
- Estimate the total transaction price (including fixed and variable consideration) that will be earned over the term of the license. Using an appropriate measure of progress, recognize revenue subject to the royalty constraint.
- Recognize the minimum guarantee (fixed consideration) using an appropriate measure of progress, and recognize royalties only when cumulative royalties exceed the minimum guarantee.

Since the new revenue standards do not prescribe a single approach that must be followed, judgment must be applied when selecting a methodology used to measure progress. We believe any of the three views are reasonable under IFRS and US GAAP, although companies should select the method that best depicts the transfer of goods and services to customers. Companies should also consider the nature of these arrangements and ensure that the measure of progress does not conflict with the core principles of the new revenue standards. Companies should also disclose their judgments in this area, if material. Other methodologies not described above may also be appropriate if they meet the core objective of the new revenue standards.

Example 5-5 – Licenses

**Facts:** A designer of jeans has a worldwide recognized brand. A global manufacturer of dolls contracts with the designer for the right to use its brand name on the dolls’ clothes. The terms of the agreement provide the doll manufacturer with rights to use the brand name on the dolls’ clothes for two years. The designer will receive $1 million upfront and 12% of all proceeds from the sales of the dolls that include branded jeans. The doll manufacturer will provide updated sales estimates on a quarterly basis and actual sales data on a monthly basis.

When does the designer recognize revenue?

**Analysis:** Revenue will be recognized over time. The license is a distinct performance obligation and the nature of the entity’s promise is to provide a right to access the entity’s IP. This would be considered symbolic IP under US GAAP.
The upfront payment of $1 million is recognized over time using an appropriate measure of progress. The variable consideration to be received by the designer depends on the level of sales of dolls and is a sales-based royalty. Therefore, the royalty component of the consideration is excluded from the transaction price until the sales have occurred, following the sales-based or usage-based royalty constraint.

**Example 5-6 – Franchise agreement**

**Facts:** An entity grants a franchisee the right to operate a restaurant in a specific market using the entity’s brand name, concept and menu for a period of ten years. The entity has granted others similar rights to operate this restaurant concept in other markets. The entity commonly conducts national advertising campaigns, promoting the brand name, and restaurant concept generally. The franchisee will also purchase kitchen equipment from the entity. The entity will receive $950,000 upfront ($50,000 for the kitchen equipment and $900,000 for the franchise right) plus a royalty, paid quarterly, based on 4% of the franchisee’s sales over the life of the contract.

When should the company recognize revenue?

**Analysis:** The franchise right is a distinct performance obligation and the nature of the company’s promise is to provide a right to access the company’s IP (symbolic IP under US GAAP). Revenue should be recognized over time.

The kitchen equipment is a distinct performance obligation. The company will satisfy this performance obligation upon transfer of the equipment. If $900,000 and $50,000 reflect the standalone selling prices of the franchise right and kitchen equipment, respectively, then the company would recognize $50,000 of the upfront fee upon transfer of the equipment.

The remaining upfront payment of $900,000 would be recognized over time (10 years in this example). The variable consideration (i.e., the 4% royalty) to be received by the restaurant company would be included in the transaction price only when the subsequent sales have occurred in accordance with the exception for sales-based royalties. The sales-based royalty should be allocated entirely to the franchise license because the variable consideration relates entirely to the company’s promise to grant the franchise license. In addition, allocating $50,000 to the equipment and allocating the sales-based royalty to the franchise license would be consistent with an allocation based on the company’s relative standalone selling prices in similar contracts.

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### Right of return

Return rights are commonly granted in the consumer markets industry and may take the form of product obsolescence protection, stock rotation, trade-in agreements, or the right to return all products upon termination of an agreement. Some of these rights may be articulated in contracts with customers or distributors, while others are implied during the sales process, or based on historical practice.

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<td>Revenue should not be recognized for goods expected to be returned, and a liability should be recognized for expected refunds to customers. The refund liability should be updated each reporting period for changes in expected refunds. An asset and corresponding adjustment to cost of sales should be</td>
<td>Revenue is recognized at the time of sale if future returns can be reasonably estimated. Returns are estimated based on historical experience with an allowance recorded against sales. Revenue is not recognized until the return right lapses if an entity is unable to estimate potential returns.</td>
<td>Revenue is typically recognized net of a provision for the expected level of returns, provided that the seller can reliably estimate the level of returns based on an established historical record and other relevant evidence. Current IFRS does not specify the balance sheet accounting for expected returns.</td>
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New guidance | Current US GAAP | Current IFRS
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recognized for the right to recover goods from customers on settling the refund liability. The asset will be initially measured at the cost of inventory sold less any expected costs to recover the goods and the impact of any reduction in the value of those goods. At the end of each reporting period, the asset should be re-measured (if necessary) based on changes in expectations.

The guidance for variable consideration is applied to determine how much revenue to recognize. Entities will recognize the amount of revenue they expect to be entitled to when control transfers to the extent it is probable (US GAAP) or highly probable (IFRS) that significant reversal will not occur in the future.

Exchanges of products for another of the same type, quality, condition, and price are not considered returns. Defective product exchanges should be considered in accordance with the guidance on warranties.

Potential impact:
The accounting for product returns under the revenue standards will be largely unchanged from current guidance under US GAAP and IFRS. There might be some consumer markets entities that are deferring revenue today because they are unable to reliably estimate returns. The new guidance requires that the impact of returns be estimated using a probability-weighted approach or most likely outcome, whichever is most predictive. Consideration received is included in revenue to the extent that it is probable under US GAAP or highly probable under IFRS, that there will be no significant reversal when the uncertainty is resolved. This could result in revenue being recognized earlier than under today’s guidance.

There is diversity in existing practice in the balance sheet presentation of expected returns. The revenue standard specifies that the balance sheet should reflect both the refund obligation and the asset for the right to the returned goods on a gross basis, which should eliminate the current diversity in presentation.

We expect that in most circumstances, a refund liability will not meet the definition of a contract liability because the refund liability does not obligate the entity to transfer future goods or services to the customer. Therefore, the refund liability should be presented separate from any contract liabilities and would not be subject to the related disclosure requirements.

Example 6-1 - Right of return

Facts: A retailer sells 100 mobile phones for $100 each. The mobile phones cost $50 and the terms of sale include a return right for 180 days. The retailer estimates that 10 mobile phones will be returned based on historical sales patterns. In establishing this estimate, the retailer uses an expected value method and estimates a 40% probability that eight mobile phones will be returned, a 45% probability that nine mobile phones will be returned, and a 15% probability that 18 mobile phones will be returned. The retailer also concludes it is probable (highly probable) that there will not be a significant reversal of revenue recognized based on this estimate when the uncertainty is resolved (i.e., once the return period has expired).

How should the retailer record the revenue and expected returns related to this transaction?

Analysis: At the point of sale, $9,000 of revenue ($100 x 90 mobile phones) and cost of sales of $4,500 ($50 x 90 mobile phones) would be recognized. An asset of $500 (cost of $50 x 10 mobile phones) would be recognized for the anticipated return of the mobile phones (assuming they are expected to be returned in a re-saleable condition), and a liability of $1,000 ($100 x 10 mobile phones) is recognized for the refund obligation. The probability of return is evaluated at each subsequent reporting date. Any changes in estimates are adjusted against the asset and liability, with adjustments to the liability recorded to revenue and adjustments to the asset recorded against cost of sales.

Warranties

Products are often sold with standard warranties that provide protection to the end customer that the product will work as advertised or intended for a fixed period of time. Many companies also offer extended warranties that cover defects that arise after the initial warranty period has expired. Standard warranties have historically been accounted for as a
cost accrual while extended warranties result in the deferral of revenue. The revenue standards draw a distinction between product warranties that the customer has the option to purchase separately (for example, warranties that are negotiated or priced separately, such as an extended warranty) and product warranties that the customer does not have the option to purchase separately (for example, a standard warranty). Management will need to exercise judgment when assessing a warranty that is not sold separately to determine if there is a service component embedded in the warranty that should be accounted for as a separate performance obligation.

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<th>New guidance</th>
<th>Current US GAAP</th>
<th>Current IFRS</th>
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<td>A warranty that can be purchased separately should be accounted for as a separate performance obligation because the company promises a service to the customer in addition to the product.</td>
<td>Warranties are commonly included with product sales. Such warranties may be governed by third-party regulators depending on the nature of the product. Estimates of warranty claims are accrued at the time of sale for the estimated cost to repair or replace covered products for standard warranties. Extended warranties result in the deferral of revenue for the value of the separately priced extended warranty. The amount deferred is amortized to revenue over the extended warranty period.</td>
<td>Management must determine if the warranty obligation is a separate element in the contract. When a warranty is not a separate element, and it represents an insignificant part of the transaction, the seller has completed substantially all of the required performance and can recognize the consideration received as revenue at the time of sale. The expected future cost relating to the warranty is recorded as a cost of sale, as the warranty does not represent a return of a portion of the sales price. Expected warranty costs are determined at the time of sale, and a provision is recognized. If the cost of providing the warranty service cannot be measured reliably, no revenue is recognized prior to the expiration of the warranty obligation. The consideration for sale of extended warranties is deferred and recognized over the period covered by the warranty. When the extended warranty is an integral component of the sale (that is, bundled into a single transaction), management ascribes a relative fair value to each component of the bundle.</td>
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<td>Warranties that provide assurance that a product will function as expected and in accordance with certain specifications are not separate performance obligations. Such warranties are accounted for in accordance with other guidance if the customer does not have the option to purchase the warranty separately.</td>
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<td>A promised warranty, or a part of the promised warranty, which is not sold separately but provides the customer with a service in addition to the assurance that the product complies with agreed specifications, creates a performance obligation for the promised service.</td>
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<td>A company that cannot reasonably separate the service component from a standard warranty should account for both together as a separate performance obligation.</td>
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**Potential impact:**

Product warranties that are not sold separately and that provide only for defects at the time a product is shipped will result in a cost accrual similar to current guidance.

Extended warranties create separate performance obligations under the new revenue standards. Therefore, revenue is recognized over the warranty period. This is similar to existing guidance.

Warranties that are separately priced might be affected as the transaction price will be allocated based on relative standalone selling prices rather than at the contract price. It may be difficult to separate standard warranties from those that also provide a service in some situations. Determining the estimated standalone selling price for the latter category when such warranties are not sold separately could also be challenging.
**Example 6-2 – Warranty, cost accrual**

**Facts:** A manufacturer sells stereo equipment. The manufacturer also provides a 60-day warranty that covers certain components of the stereo equipment. The warranty is not sold separately by the company and is designed to provide assurance that the product will function as expected.

How should the manufacturer account for the warranty?

**Analysis:** The manufacturer should accrue the cost it expects to incur to satisfy the warranty similar to existing contingency (US GAAP) or provisions (IFRS) guidance.

**Example 6-3 – Warranty, separate performance obligation**

**Facts:** A manufacturer sells stereo equipment. A customer has elected to also purchase the optional 12-month extended warranty.

How should the manufacturer account for the warranty?

**Analysis:** The manufacturer should treat the 12-month warranty as a separate performance obligation. A portion of the transaction price is allocated to the warranty based on its relative standalone selling price and recognized as revenue when the warranty obligation is satisfied, typically after the standard “manufacturer’s” warranty has expired. The manufacturer will need to assess the pattern of warranty satisfaction to determine when revenue should be recognized (that is, ratably or some other pattern).

Consumer markets companies often offer customers other after-sale services, in addition to warranties, in conjunction with products and will need to evaluate whether those services represent a separate performance obligation. Examples of other after-sale services can include installation, product protection, and service plans.

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**Principal versus agent (Gross versus net)**

Some arrangements involve two or more unrelated parties that contribute to providing a specified good or service to a customer. In these instances, management will need to determine whether the company has promised to provide the specified good or service itself (as a principal) or to arrange for those specified goods or services to be provided by another party (as an agent). This determination often requires judgment, and different conclusions can significantly impact the amount and timing of revenue recognition.

Retailer arrangements that will require evaluation might include: service offerings (e.g., an electronics retailer selling third-party cellular service plans), extended warranties, product protection plans, installation services, and third-party gift card sales. Consumer product arrangements that will require evaluation might include direct shipments from suppliers or contract manufacturers to third-party distributors, retailer customers, or end customers. Other types of arrangements frequently involve more than two unrelated parties, and must be assessed to determine whether a company is the principal or an agent in the arrangement.

Management should first obtain an understanding of the relationships and contractual arrangements among the various parties. This includes identifying the specified good or service being provided to the end customer and determining whether the entity controls that good or service before it is transferred to the end customer. It is not always clear whether the company obtains control of the specified good or service. The revenue standards provide indicators to help management make this assessment.

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<td>A company is the principal and should report revenue on a gross basis if it controls the specified good or service before that good or service is transferred to the customer.</td>
<td>Current US GAAP provides indicators to determine whether gross or net reporting is more appropriate. The indicators that suggest gross reporting are appropriate are:</td>
<td>A company is a principal if it is exposed to risks and rewards when selling goods or providing services. Indicators that a company is acting as a principal in an arrangement are:</td>
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<tr>
<td>Indicators that assist entities in determining whether it controls the</td>
<td>• The company is the primary obligor in the arrangement.</td>
<td>• The company is the primary obligor.</td>
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New guidance

The company has primary responsibility for fulfillment of the contract.
- The company has inventory risk.
- The company has discretion in establishing the price.
Obtaining title momentarily before transferring a specified good or service to a customer does not necessarily constitute control.
The company is an agent if its performance obligation is to arrange for another party to provide the specified goods or services. An agent does not control the specified good or service provided by another party before that service is transferred to the customer.

Current US GAAP

- The company has general inventory risk.
- The company has latitude in establishing price.
- The company changes the product or performs part of the service.
- The company has discretion in supplier selection.
- The company is involved in the determination of product or service specifications.
- The company has physical loss inventory risk – after customer order or during shipping.
- The company has credit risk.
The following indicators suggest net reporting is appropriate:
- The company’s supplier is the primary obligor in the arrangement.
- The amount the company earns is fixed.
- The supplier has credit risk.

Current IFRS

- The company has inventory risk.
- The company has pricing latitude.
- The company has credit risk.
An indicator that a company is an agent is if the company earns a predetermined fee.

Potential impact:

Although the indicators in the new standards are similar to those in the current guidance, the purpose of the indicators is different. The new standards require a company to assess whether it controls the specified good or service, and the indicators are intended to support the control assessment. In contrast, the current guidance is focused on assessing whether the company has the risks and rewards of a principal. Entities will therefore need to reassess their arrangements through the lens of the control principle.

The new standards also provide more guidance on the unit of account that should be used in the gross versus net assessment, which could result in changes to the assessment as compared to current guidance.

Amounts collected on behalf of third parties

Companies often collect amounts from customers that must be remitted to a third party (for example, collecting and remitting taxes to a governmental agency). Taxes collected from customers could include sales, use, value-added, and some excise taxes. Amounts collected on behalf of third parties, such as certain sales taxes, are not included in the transaction price as they are collected from the customer on behalf of a third party, such as the government.
Taxes that are based on production, rather than sales, are typically imposed on the seller, not the customer. A company that is obligated to pay taxes based on production is the principal for those taxes, which are recognized in operating expense with no effect on revenue.
New guidance

The transaction price is defined to exclude amounts collected on behalf of third parties, such as certain sales taxes. A company will need to assess each type of tax, on a jurisdiction-by-jurisdiction basis, to determine which amounts to present as revenue on a gross basis (when the company is determined to be the principal) and which amounts to exclude from revenue as amounts collected on behalf of third parties (when the company is determined to be the agent).

US GAAP reporters may present, as an accounting policy election, amounts collected from customers for sales and other taxes on a net basis. If presented on a net basis, such amounts would be excluded from the determination of the transaction price. Companies will be required to disclose the policy they choose to apply. Such elections are not permitted under IFRS.

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<td>Taxes within the scope of ASC 605-45 include any tax assessed by a governmental authority that is both imposed on and concurrent with a revenue transaction between a seller and a customer (e.g., sales, use, value added, and excise taxes). Reporting these taxes on either a gross basis (included in revenues and costs) or net basis (excluded from revenues) is an accounting policy election that requires disclosure.</td>
<td>IAS 18 explains that revenue includes only the economic benefits that are received or receivable by the entity on its own account. It excludes amounts collected by the entity, such as sales taxes, that the company collects on behalf of the third party. There is no specific guidance on excise or use taxes.</td>
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Potential impact

The requirement to evaluate each type of tax on a jurisdiction-by-jurisdiction basis, to determine which amounts should be reported gross and which should be reported net, could be a significant undertaking for some companies, particularly those that operate in numerous tax jurisdictions with different tax regimes.

The explicit guidance currently in US GAAP for determining whether to present certain items billed to customers (i.e., out-of-pocket expenses) as revenue or as a reduction of costs has been superseded by the new revenue standard.

The name of the tax (for example, sales tax or excise tax) is not always determinative when assessing whether the company is the principal or an agent for the tax. Management needs to look to the underlying characteristics of the tax and the tax laws in the relevant jurisdiction to determine whether the company is primarily obligated to pay the tax or whether the tax is levied on the customer.

A company that reports under US GAAP and makes the policy election to report amounts collected on behalf of customers on net basis should comply with the general requirements for disclosures of accounting policies.
**About PwC’s Consumer Markets practice**

Our Consumer Markets practice is a leading financial accounting, tax and advisory consulting business serving the consumer products manufacturers, retailers and transportation and travel industries. Our combined Consumer Markets practice allows us to understand issues across the entire supply chain, from source to sale, and to easily transfer our knowledge to clients related to attesting to and ensuring the accuracy of financial statements and reporting systems, providing local, state and global tax and compliance advice, managing and mitigating enterprise risk, improving business processes and operations, implementing technologies and helping clients with mergers and acquisitions to drive growth and improved profitability.

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