New Revenue Recognition Landscape for Retailers

PROFESSIONALS

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PRACTICE AREAS

Revenue Recognition/
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INDUSTRIES

Manufacturing, Retail &
Distribution

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As a result of the new revenue recognition standard issued by the Financial Accounting Standards Board (FASB) and contained in Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, retail entities may need to change certain revenue recognition practices. Many retailers initially assumed that the new standard would have a minimal impact on their operations. However, there are several unexpected areas which should be considered.

This major overhaul of the revenue recognition framework (formerly ASC 605) went into effect for calendar year-end public entities and private entities on January 1, 2018, and January 1, 2019, respectively.

The following are selected areas that may present challenges and should be analyzed by retailers:

Gift Certificates and Gift Cards

The use of gift certificates and gift cards is very common by retailers and are usually sold for cash. They are often used by customers to obtain products or services in a future period up to the specific monetary value of the transaction. The amount of gift certificates or cards that are forfeited is commonly referred to as breakage and will usually result in recognition of income for a retailer. However, the timing of recognition depends on expected customer behavior and the legal restrictions in the relevant jurisdiction.

When a customer purchases a gift card, it is often for the pre-paying of goods or services to be delivered in the future. The retailer must transfer the goods or services in the future which creates a performance obligation. The retailer should recognize a liability contract for the amount of the prepayment and derecognize the liability (and recognize revenue) when it delivers the performance obligation. The portion of a customer's rights that remain unexercised is referred to as breakage. There is diversity in the current accounting for breakage with three acceptable methods to recognize breakage revenue: (1) as the retailer is legally released from its obligation (e.g., at redemption or expiration) (2) at the point at which redemption becomes remote; or (3) in proportion to actual gift card redemptions.

Similar to today's accounting models, retailers will continue to recognize a liability contract for the obligation to deliver goods and services. Under the new standard, retailers that expect to be entitled to breakage should estimate the breakage amount and recognize breakage as revenue in proportion to the pattern of rights exercised by the customer. If the retailer does not expect to be entitled to a breakage amount, it will recognize breakage revenue when the likelihood of the customer exercising its right 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.

Customer 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.

A retailer will need 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. The consideration payable by a retailer to a customer is accounted for as a reduction of the transaction price unless the payment is for a distinct good or service. If the retailer receives a distinct good or service, it must determine if its fair value can be reasonably estimated. If the retailer cannot reasonably estimate the fair value of the distinct good or service, the payment made to the customer is treated as a reduction in the transaction price. Otherwise, the cost of the good or service provided to the retailer is the lesser of the fair value of the good or service provided to the retailer and the amount payable to the customer by the retailer. The cost is accounted for in the same manner as if the retailer had bought the good or service from a third-party. Any excess of the amount payable to the customer over the fair value of the good or service is treated as a reduction of the transaction price.

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.

Variable consideration is estimated using either an expected value or a likely outcome method – whichever provides the best estimate. Variable consideration is included in the transaction price to the extent it is probable that there will not be a significant reversal in the amount of cumulative revenue recognized when the uncertainty is resolved. Judgment will often be needed to determine whether it is probable, as there will not be a significant reversal in the amount of cumulative revenue. The new standard provides indicators that might suggest when such a reversal may take place.

Retailers that defer revenue recognition under current guidance because the price is not fixed or determinable might be significantly affected by the new standard. In a situation when the price is fixed, but the retailer has a history of granting concessions, retailers would be required to recognize the minimum amount of entitled revenue, as long as it is probable 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 retailers will need to recognize revenue before all contingencies are resolved, which might be earlier than under current practice. Management might need to put new processes into place to monitor estimates on an ongoing basis as more experience is obtained.

Customer Loyalty Programs

When allocating the transaction price, a customer loyalty program should be considered with incentives to purchase their products or services. Retailers often use these programs to enhance brand loyalty and increase revenue by providing customers with incentives to purchase their products or services. Each time a customer buys a retailer's goods or services, the retailer provides the customer with award credits. The customer can redeem the credits for awards such as free or discounted goods or services. Under the new standard, the awarded credits are a separate performance obligation to which consideration is allocated.

An option to acquire additional goods or services gives rise to a separate performance obligation if the option provides a material right that the customer would not receive without entering into that contract. The revenue standards require management to estimate the transaction price to be allocated to the separate performance obligations and to recognize a contract liability for the performance obligations that will be satisfied in the future. The customer is paying for future goods or services to be received when the award credits are issued in conjunction with a current sale. The retailer recognizes revenue for the option when those future goods or services are transferred to the customer or when the option expires.

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 the legacy revenue recognition model.

The accounting for loyalty programs is expected to result in additional complexities and disclosure requirements for retailers that currently apply the incremental cost model under the legacy revenue recognition model. Retailers will need to account for points issued and rights earned under these programs as separate performance obligations, which could involve developing more in-depth accounting processes to enable management to comply with the new standard. Specifically, retailers will need to consider concepts such as redemption patterns, breakage estimates and the value of the loyalty award.

Rights of Return

Retailers 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, retailers will need to apply judgment when to evaluate when control transfers to ultimately determine the timing of revenue recognition. This may be different than under legacy guidance.

Revenue should be recognized when control of the goods or services is transferred to the customer. A retailer 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 can 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 the following: (a) the retailer has a present right to payment for the asset; (b) the customer has legal title to the asset; (c) the retailer transferred physical possession of the asset; (d) the customer has the significant risk and rewards of ownership; and, (e) the customer has accepted the asset.

The effect of the new standard on retailer distribution arrangements will depend on the terms of the current contract. The new standard requires 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). 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 standard. The main reason that timing of revenue recognition could change for some retailers is that 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 the control has transferred under the new standard, but additional indicators will also need to be considered. Control can transfer before all of the risks and rewards transfer. If the retailer can require the customer or distributor to return the product (that is, it has a call option), control has not transferred to the customer.

Conclusion

It's important that a company's management team become familiar with the new standard and evaluate the impacts on their operations. They should also be aware of the domino effects of the new standard, including what this may mean for complying with EBITDA and other financial performance-related covenants, as well as income tax implications and their overall internal control environment. To address these changes, management should consider the various transition methods that the FASB has provided, begin to train their accounting and finance personnel and monitor any additional updates provided by the FASB.

For more information on how the new revenue recognition changes may impact your business, please contact John Kishi at John.Kishi@hcvt.com