Consumer Products Spotlight

Redefining Revenue Recognition

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Executive summary

- On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their final standard on revenue from contracts with customers. The standard, issued as Accounting Standards Update 2014-09 (and codified as Topic 606 in the FASB Accounting Standards Codification) by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance[1]).
- The Institute of Chartered Accountants of India (ICAI) has recently issued an Exposure Draft (ED) of the proposed Indian Accounting Standard (Ind AS) 115, Revenue from Contracts with Customers i.e. the proposed IFRS Converged accounting standard for Indian entities, which is similar to IFRS 15.
- The new revenue recognition standard will require consumer products entities to reconsider many of their existing accounting policies and practices. For example, variable consideration that may be created by sales incentives such as volume discounts or customer rebates will need to be estimated and may be constrained.
- The timing of revenue recognition could significantly change under the new revenue recognition standard. For example, entities that currently defer revenue related to goods shipped with "synthetic FOB destination" terms might instead be required to recognise revenue associated with those goods upon shipment. In contrast, revenue may be deferred longer than under current practice when a material right is identified as a performance obligation and the allocated transaction price is recognised when (or as) the material right is exercised.
- The new standard requires significantly more extensive disclosures than current revenue standards. Therefore, consumer products entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.
- This Consumer Products Spotlight discusses the framework of the new revenue model and highlights key accounting issues and potential challenges for consumer products entities.

The new revenue standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-

[1] The U.S. Securities and Exchange Commission (SEC) has indicated that it plans to review and update the revenue recognition guidance in SEC Staff Accounting Bulletin (SAB) Topic 13, "Revenue Recognition," in light of the issue of the new standard. The extent to which the new standard will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Background

The goals of the new revenue recognition standard are (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing “a more robust framework for addressing revenue issues”; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The new revenue recognition standard states that the core principle for revenue recognition is that an “entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”

The new standard indicates that an entity should perform the following five steps in recognising revenue:-

- “Identify the contract(s) with a customer” (step 1);
- “Identify the performance obligations in the contract” (step 2);
- “Determine the transaction price” (step 3);
- “Allocate the transaction price to the performance obligations in the contract” (step 4); and
- “Recognise revenue when (or as) the entity satisfies a performance obligation” (step 5)

As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

Thinking It Through

As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. Entities are also required to provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the revenue model; and (3) the assets recognised from costs to obtain or fulfil a contract with a customer.

Key Accounting Issues

This consumer products spotlight discusses the new revenue model and highlights key accounting issues and potential challenges for consumer products entities.

Promotional Programs, Options for Additional Goods or Services, and Sales Incentives

Consumer products entities are often involved in promotional programs with their customers and may offer customers a variety of sales incentives. In accounting for these activities under the new revenue recognition standard, consumer products entities will need to assess (1) whether to treat promotional programs as a cost (expense) or as a reduction of revenue, (2) whether an option for an additional good or service is a separate performance obligation, and (3) the impact of sales incentives on the transaction price.

Promotional Programs

Consumer products entities may pay (or offer certain allowances to) the customer in exchange for specified promotional benefits (e.g., co-op advertising, specific shelf space, special promotions). The new revenue recognition standard provides guidance on determining when these benefits represent a separate good or service provided by the customer (i.e., a cost) as opposed to an adjustment to the transaction price (i.e., a reduction of revenue). Specifically, the new revenue recognition standard requires entities to treat the benefit received from a customer as a cost only if it constitutes a distinct good or service. Under the revenue model, a good or service is distinct if both of the following criteria are met:

Although the new revenue recognition standard supersedes current guidance, the new guidance is not expected to significantly change the income statement characterisation of many common types of allowances.

- *Capable of being distinct* — "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer."
- Distinct within the context of the contract — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract."

If these criteria are met, the benefit acquired represents a separate good or service, and any amounts paid or payable to the customer would be recognised as a cost (expense). In addition, amounts paid (or expected to be paid) for the distinct good or service would be limited to the fair value of the distinct good or service received. Any consideration paid to the customer (or offered in allowances) above the fair value of the distinct good or service received would be recognised as a reduction of revenue.

Thinking It Through

Although the new revenue recognition standard supersedes current guidance, the new guidance is not expected to significantly change the income statement characterisation of many common types of allowances. However, consumer products entities will need to carefully examine the facts and circumstances of their promotional activities in the context of the standard's more principles-based model.

Options for Additional Goods or Services

Under the new revenue recognition standard, an incentive that gives a customer the option to acquire additional goods or services (potentially at a discount) may represent a separate performance obligation if it provides a “material right” to the customer that it would not have received without entering into the contract. If an incentive is deemed as a separate performance obligation, an entity would allocate a portion of the transaction price to the incentive on a relative stand-alone selling price basis and recognise revenue when control of the goods or services underlying the incentive is transferred to the customer (provided that the customer exercises its right to the incentive) or when the incentive expires.

Thinking It Through

Under the new revenue recognition standard, an entity may need to use significant judgment when determining whether an option to acquire additional goods or services gives the customer a material right that it would not have received without entering into the contract. In addition, an entity should use judgment when allocating the contract consideration between (1) goods or services initially sold and (2) any option to acquire additional goods or services. Consumer products entities currently applying the cost accrual model to future purchase options would be required to reassess their accounting policies in accordance with the standard’s requirements.

The following example, illustrates the application of the revenue recognition requirements to a discount voucher that gives the customer a material right related to future purchases.

Example

An entity enters into a contract for the sale of Product A for Rs.1,000. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to Rs.1,000 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

Because all customers will receive a 10% discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10% (that is, the additional 30% discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

To estimate the stand-alone selling price of the discount voucher in accordance with the new revenue recognition standard, the entity estimates an 80% likelihood that a customer will redeem the voucher and that a customer will, on average, purchase Rs.500 worth of additional products. Consequently, the entity’s estimated stand-alone selling price of the discount voucher is Rs.120 (Rs.500 average purchase price of additional products × 30% incremental discount × 80% likelihood of exercising the option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the Rs.1,000 transaction price are as follows:

Performance Obligation	Stand-alone Selling Price
Product A	₹1,000
Discount voucher	₹120
Total	₹1,120

Example (continued)

Performance Obligation	Allocated Transaction Price	
Product A	₹890	(1,000 / 1,120 x 1,000)
Discount voucher	₹110	(120 / 1,120 x 1,000)
Total	₹1,000	

The entity allocates Rs.890 to Product A and recognises revenue for Product A when control transfers. The entity allocates Rs.110 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

Sales Incentives

Sales incentives, such as volume discounts, rebates, or price concessions, may create variability in the pricing of the goods or services offered to the customer. Under the new revenue recognition standard, if the transaction price is subject to variability, an entity would be required to estimate the transaction price by using either (1) the "expected value" approach (i.e., a probability-weighted amount) or (2) the "most likely amount" approach (i.e., management's best estimate), "depending on which method the entity expects to better predict the amount of consideration to which the entity will be entitled." Therefore, entities will need to use judgment in determining whether the expected value or the most likely amount is more predictive of the amount of consideration in the contract.

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Regardless of which approach is used to estimate the transaction price, entities would include the estimated consideration in the transaction price only if it is "probable" that any subsequent changes in the estimate would not result in a significant reversal of revenue. Accordingly, entities may have to recognise some or all of the probability-weighted amount or most likely amount.

Thinking It Through

Entities should consider factors that could indicate that an estimate of variable consideration is subject to significant reversal, such as susceptibility to factors outside the entity's influence (e.g., subsequent third-party sales, volatility in a market, weather conditions), limited experience with similar types of contracts, long period before uncertainty is resolved, practices of providing concessions, or a broad range of possible consideration amounts. If it is probable that a change in the entity's estimate of variable consideration would result in a significant reversal of revenue, the entity would include in the transaction price some or all of an estimate of variable consideration for which a significant revenue reversal is not probable (this is commonly referred to as the "constraint guidance"). The new revenue recognition standard requires this estimate to be updated in each reporting period to reflect changes in facts and circumstances.

Right of Return

To ensure customer satisfaction, consumer products entities often grant customers the right to return a product. In a manner consistent with current practice, the new revenue recognition standard allows an entity to recognise revenue from the sale of goods subject to a right of return (i.e., the entity's stand-ready obligation to accept a return is not deemed a separate performance obligation). However, the new revenue recognition standard's guidance on estimating the transaction price may differ from current practice. Under existing guidance, usually an entity can recognise revenue when a right of return is granted if it meets certain criteria, including an ability to "reasonably estimate" the amount of future returns. Under the new standard, however, an entity must apply the new guidance on estimating and constraining variable consideration to estimate the amount of consideration to which it expects to be entitled.

The new revenue recognition standard specifically requires an entity to recognise separately on its balance sheet both a refund liability (for the amount it expects to refund to the customer) and an asset (for its right to recover the product from the customer, subject to any potential impairment).

Thinking It Through

The new guidance on revenue recognition for a sale with a right of return is largely consistent with current practice. However, the overall principle of the constraint guidance (no significant revenue reversal) may result in different conclusions in certain instances. Accordingly, entities should carefully assess their facts and circumstances.

In addition, the guidance specifically requires an entity to recognise separately on its balance sheet both a refund liability (for the amount it expects to refund the customer) and an asset (for its right to recover the product from the customer, subject to any potential impairment). Entities that do not currently show those amounts separately on the balance sheet will be required to do so (subject to potential impairment if any indicators of impairment exist).

Warranties

Consumer products entities often sell products with warranties that assure customers that the products comply with agreed-upon specifications. In some cases, entities may also offer more extensive warranties (e.g., warranties that provide services for a fixed period after the initial warranty period has expired).

The new revenue recognition standard allows entities to continue to use a cost accrual model to account for warranty obligations, but only for warranties ensuring that the good or service complies with agreed-upon specifications. To the extent that a warranty provides a service beyond ensuring that the good or service complies with agreed-upon specifications, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognised as it is satisfied). Further, if the customer has the option to purchase the warranty separately, it would also be accounted for as a performance obligation.

Product liabilities, such as compensation paid by an entity for harm or damage caused by its product, do not represent a performance obligation in the contract and would continue to be accounted for in accordance with the existing literature on loss contingencies/ Provisions.

Thinking It Through

The new revenue recognition guidance should not change the accounting for most warranties (i.e., typical warranties assuring that the good or service complies with agreed-upon specifications), which are generally accounted for under a cost accrual model. However, consumer products entities may want to reassess all of their warranties to ensure that the warranties are not providing any services beyond assuring the customer that the product complies with agreed-upon specifications.

Licenses

The granting of licenses to customers (e.g., for the use of images or brand names) is common in the consumer products industry. The new revenue recognition guidance provides guidance on how an entity would account for the licensing of its intellectual property.

The entity must first assess whether a license is distinct, as defined by the new standard, from other promised goods or services in the contract (see **Promotional Programs** above for a discussion of the criteria used to determine whether a good or service is distinct). If the license is not distinct, it should be combined with other promised goods or services and accounted for as a performance obligation. Conversely, if the license is a distinct performance obligation, the entity must assess the nature of the promised license (i.e., whether the license gives the customer a “right to access the entity’s intellectual property as it exists throughout the license period” or a “right to use the entity’s intellectual property as it exists at the point in time at which the license is granted”). A license gives the customer access to an entity’s intellectual property (and, therefore, control of the license is transferred, and revenue is recognised, over time) when the following criteria are met:

- “The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights.”
- “The rights granted by the license directly expose the customer to any positive or negative effects of the entity’s activities identified in [the sentence above].”
- “Those activities do not result in the transfer of a good or a service to the customer as those activities occur.”

If the license does not meet these criteria, it would represent a transfer of a right to use the entity's intellectual property as it exists at a point in time (and, therefore, control of the license would be transferred, and revenue would be recognised, at a point in time).

The new revenue recognition standard's constraint guidance constitutes an exception to revenue recognition under the standard's model that would preclude an entity from recognising consideration for an estimate of sales- or usage-based royalties to be paid in exchange for a license of intellectual property. Consideration from arrangements involving such royalties is recognised as revenue only when the customer's subsequent sales or usage occur.

If a license does not meet the new revenue recognition standard's "right to access" criteria, it would represent a transfer of a right to use the entity's intellectual property as it exists at a point in time.

Thinking It Through

When a license is distinct and deemed to be transferred at a point in time, the new revenue recognition guidance may require up-front recognition of license revenue unless some or the entire transaction price is subject to the general constraint guidance or is in the form of a sales- or usage-based royalty. Therefore, an entity may need to recognise non-refundable up-front license fees and future minimum license fees (not subject to sales indexing) as revenue upon transferring a license to a customer. Meanwhile, any sales-based royalty payments would not be recognised as revenue until the subsequent sales occur.

Shipping Terms

Consumer products entities may ship goods "FOB shipping point" but have arrangements with their customers under which the seller continues to bear risk of loss or damage (either explicitly or implicitly) that is not covered by the carrier while the product is in transit. If damage or loss occurs under these circumstances, the seller is obligated to provide (or has a practice of providing) the buyer with replacement products at no additional cost. The seller may insure this risk with a third party or "self-insure" the risk. Such shipping terms are often called synthetic FOB destination shipping terms because the seller has retained the risk of loss or damage during transit. Under these terms, all risks and rewards of ownership have not been substantively transferred to the buyer, and it would not be appropriate to recognise revenue before the goods are ultimately delivered to the buyer under current revenue recognition guidance.

Under the new revenue recognition guidance, entities are required to recognise revenue by using a control-based model rather than the risk-and-rewards model of current revenue recognition. Accordingly, entities would consider the following indicators in evaluating the point at which control of an asset has been transferred to a customer:

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

Under the new revenue recognition guidance, entities are required to recognise revenue by using a control-based model rather than the risk-and-rewards model of current revenue recognition.

Thinking It Through

Under the new standard, arrangements involving synthetic FOB destination shipping terms may give rise to two performance obligations: (1) sale of a product and (2) protection against the risk of loss during transit. Instead of deferring all revenue recognition, consumer products entities would need to allocate the transaction price to each identified performance obligation and assess the satisfaction of each performance obligation separately. In those cases, revenue recognition could be accelerated depending on the determination of when control related to the underlying performance obligations is transferred.

Sell-Through Arrangements

Consumer products entities often enter into arrangements in which they deliver products to a distributor or dealer ("intermediary"), who then sells the product to the customer. Under existing guidance, revenue at times may be deferred until the intermediary has subsequently sold the goods to the customer, often because the sales price may not be fixed or determinable until final sale to the customer. The new standard precludes an entity from recognising revenue for a good physically transferred to a third party on consignment until control of that good is transferred to the third party. However, if the arrangement between the entity and the intermediary is not a consignment arrangement, an analysis of the control indicators for determining at what point in time control is transferred (see **Shipping Terms** above) is critical to determining when revenue may be recognised.

Thinking It Through

Consumer products entities will need to assess the terms of their arrangements with intermediaries and use judgment to determine when control of the underlying assets is transferred to the customer.

If control is deemed to pass at the point in time when goods are supplied to the intermediary, revenue may be recognised earlier than under current practice. In such a situation, the sales price could be variable because of the entity's pricing terms with the intermediary. Accordingly, the entity would be required to estimate the transaction price to which it expects to be entitled and to consider the constraint guidance, specifically the probability of future revenue reversals (see **Sales Incentives** above), before recognising revenue.

If control of the goods or services delivered by an entity has been transferred, the entity should assess whether the new guidance on rights of return (see **Right of Return** above) is applicable.

Bill-and-hold Arrangements

A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future.

Under the new revenue recognition guidance, entities are required to recognise revenue by using a control-based model which refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, in some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession

For a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

- "the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement)";
- "the product must be identified separately as belonging to the customer";
- "the product currently must be ready for physical transfer to the customer"; and

- “the entity cannot have the ability to use the product or to direct it to another customer.”

Thinking It Through

Consumer products entities will need to assess whether control of the goods have been transferred and have met the bill-and-hold criteria to recognize revenue under the new standard. If the revenue recognition criteria is met, the arrangements may give rise to two performance obligations: (1) sale of a product and (2) custodial services resulting in a portion of the transaction price being allocated to both the performance obligations.

Disclosures

The new standard requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The standard's disclosure requirements, which are significantly more comprehensive than those in existing revenue standards, include the following (with certain exceptions for nonpublic entities):

The new standard requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

- Presentation or disclosure of revenue and any impairment losses recognised separately from other sources of revenue or impairment losses from other contracts.
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the new standard also provides implementation guidance).
- Information about (1) contract assets and liabilities (including changes in those balances), (2) the amount of revenue recognised in the current period that was previously recognised as a contract liability, and (3) the amount of revenue recognised in the current period that is related to performance obligations satisfied in prior periods.
- Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied)" and when the entity expects to recognise that amount as revenue.
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).
- Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortisation methods).
- Information about the policy decisions (i.e., whether the entity used the practical expedients for significant financing components and contract costs allowed by the new standard).

Considerations and Challenges for Consumer Products Entities

Systems, Processes and Controls

To comply with the new standard's accounting and disclosure requirements, consumer products entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Consumer products entities with large volumes of sales deals may find it operationally challenging to assess each sales deal to categorise and account for customer incentives in accordance with the new standard. Such entities may need to make substantial system modifications to facilitate this process.

To comply with the new standard's accounting and disclosure requirements, consumer products entities will have to gather and track information that they may not have previously monitored.

Consumer products entities may also face challenges when they recognise as an asset certain costs of obtaining or fulfilling a contract (as opposed to recognising such costs as expenses immediately, if the amortisation period is one year or less). In such cases, consumer products entities may need to revise their accounting practices and make appropriate system modifications to track data on contract duration, contract costs, and periodic amortisation and impairment testing of capitalised costs.

Further, to ensure the effectiveness of internal controls over financial reporting, management will need to assess whether additional controls should be implemented. Consumer products entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the new standard.

Note that the above are only a few examples of changes consumer products entities may need to make to their systems, processes, and controls. Consumer products entities should evaluate all aspects of the new standard's requirements to determine whether any other modifications may be necessary.

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain aspects of the new standard's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for consumer products entities to consider how the new standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

Exposure Draft of Ind AS 115 does not provide for any transitional provisions and retrospective applications.

Thinking Ahead

Although the exposure draft on revenue recognition is not effective until finalised by the ICAI and notified by the Ministry of Corporate Affairs, consumer products entities should start carefully examining the exposure draft and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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