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New revenue standard issued

Potential challenges in the retail industry

The new revenue recognition standard will likely present different levels of complexity for many retail companies, notably greater judgment in recognizing revenue and costs related to loyalty programs, gift cards, and warranties. It may also change the timing of revenue recognition from current practice.

Background

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update, *Revenue from Contracts with Customers* in May 2014. The standard provides companies with a single model for use in accounting for revenue arising from contracts with customers, and supersedes current revenue recognition guidance, including industry-specific revenue guidance. The core principle of the model is to recognize revenue when control of the goods or services transfers to the customer, as opposed to recognizing revenue when the risks and rewards transfer to the customer under the existing revenue guidance.

The effective date for public registrants has been deferred to 2018 for calendar year-end (annual reporting periods beginning after December 15, 2017). Early adoption as of the original effective date (2017 for calendar year-end) is permitted. The guidance permits companies to either apply the requirements retrospectively to all prior periods presented, or apply the requirements in the year of adoption, through a cumulative adjustment.

The delayed effective date and transition options are intended to allow companies a reasonable timeframe to comply. However, addressing some areas of the FASB Accounting Standards Codification may require longer lead-time, particularly related to revenue or billing systems where separation and/or allocation changes may be required, so companies should perform a preliminary analysis of the new requirements on a timely basis.

Considerations and challenges

Although many retailers may initially assume that this standard will have minimal impact within the industry, there are several unexpected issues which may present challenges. Examples of some of the challenges are as follows:

Customer reward points, "bounce back" coupons, and other loyalty programs — Options that allow customers to acquire additional goods or services for free or at a discount are common in the retail industry (e.g., customer reward points, loyalty programs, or other discounts on future goods or services). Under the model, such an option would likely represent a separate performance obligation if it gives the customer a material right that it otherwise would not have received without entering into the contract. Retail entities applying a cost accrual model to existing reward and loyalty programs may need to amend their accounting policies in accordance with the above requirements, essentially resulting in revenue deferral. Another incentive used by many retailers is the bounce back coupon (a coupon awarded to customers upon completing a transaction in order to entice them to complete another transaction within a specified period of time). While the new standard does not provide specific guidance on this issue, bounce back coupons may need to be accounted for similar to a customer reward points (if the bounce back coupon is deemed to provide the customer a 'material right').

Transaction price calculations — In addition to assessing whether certain sales incentives provide a customer with a material right which should be accounted for as a separate performance obligation, sales incentives may also create variability in the pricing of the goods or services offered to the customer. Under the standard, if the transaction price is subject to variability, an entity is required to estimate the transaction price using either the "expected value" or "most likely amount" approach. Companies may need to develop methods to calculate or estimate the transaction price, including the impact of variable amounts, and may also need a process to update these estimates each reporting period. It will also be important to consider data maintenance requirements relative to the transaction price.

Rights of return — To ensure customer satisfaction, retail entities often grant customers the right to return a product. The new model allows entities to recognize revenue for goods subject to a right of return if it is probable that doing so would not result in a significant revenue reversal. The standard specifically indicates that an entity must separately recognize a refund liability for the amount expected to be refunded and an asset for the entity's right to recover the product from the customer subject to potential impairment.

Gift cards and layaway sale deposits — Retail entities may give customers the right to make a nonrefundable prepayment to the entity for the right or option to receive future goods or services (e.g., gift cards, gift certificates, and layaway sale deposits). The new model addresses how to recognize revenue for customers' rights that are not expected to be exercised (e.g., breakage on gift cards or gift certificates sold to customers or layaway sales deposits that are forfeited). The new model provides that an entity would recognize the effects of the expected breakage "in proportion to the pattern of rights exercised by the customer" when the amount is not subject to significant reversals. Otherwise, the expected breakage would be recognized "when the likelihood of the customer exercising its remaining rights becomes remote."

Other potential issues

Retailers should consider situations where long-term commitments are bundled with current sales, to consider whether separate performance obligations are being transferred that are satisfied over different timeframes. Examples could include durable equipment service that might include ongoing service offers over the product's remaining life.

In general, retailers with pharmacy operations or other businesses that include third-party reimbursement will need to consider the variable transaction price requirements of the new standard, on the timing and amount of third-party reimbursement recognition.

Disclosures — The disclosure requirements under the standard are significant and may require modification to financial management reporting processes and systems. Additional disclosures include, but are not limited to, disaggregation of revenue, certain information about changes in contract asset and liability balances and contract costs, and information related to the amount of the transaction price allocated to performance obligations not yet satisfied.

Tax — Certain tax implications may arise as taxpayers often follow the financial reporting revenue recognition methods in the determination of taxable income and transaction tax obligations. The changes may have cash tax implications, may require federal tax accounting method changes, or give rise to new tax temporary differences that may need to be captured, calculated, and tracked through tax provision processes and systems. Taxpayers who do not follow financial reporting methods for tax may also need to consider the impact of these changes on tax reporting and may need to change their computations and procedures, as well as consider potential tax method changes. Similar implications may arise in foreign jurisdictions that impose tax based upon statutory reporting maintained under either International Financial Reporting Standards or U.S. Generally Accepted Accounting Principles, as this change may impact both standards.

Other implications

Organizations may need to consider other project needs, including:

- Implementation of updated or new processes, controls, and systems, where required
- Determination of new monthly closing process steps to accommodate the new requirements

- Steps to estimate the impact of the new standard, to facilitate understanding and planning by other key stakeholders
- Effective training and communication of new requirements
- Effective program and resource management related to this effort

Getting started

Some effective first steps to consider as you begin to evaluate the implications of the potential new standard may include:

- Evaluating significant revenue streams and key contracts to identify the specific revenue recognition changes required and the specific business units where these changes may have the greatest impact
- Addressing the longer lead-time areas where new calculation rules or revised allocation processes may be required
- Establishing a granular project plan and roadmap to manage the effort across multiple business units and countries

How Deloitte Advisory can help

We have an experienced team of professionals, both in the U.S. and globally across the member firms of Deloitte Touche Tohmatsu Limited, who can assist in developing an action plan to help you implement the new revenue recognition standard.

These capabilities includes the full breadth of services and competencies needed to help clients address these issues, and would include accounting assistance, help with process revisions, support in making system changes (including development of system business requirements), tax and other matters.

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