

## Consumer Products Spotlight

# How the Converged Revenue Recognition Model May Affect Sales Targets

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## The Bottom Line

The proposed revenue model requires management to use greater judgment in recognizing revenue and related costs and may change the timing of revenue recognition from current practice.

- On November 14, 2011, the FASB and IASB (the “boards”) jointly issued their revised exposure draft (ED) *Revenue From Contracts With Customers*. During the ED’s comment period, which ended on March 13, 2012, the boards received over 300 comment letters.
- The consumer products (CP) industry did not actively oppose any aspect of the revised ED, suggesting that the industry generally views the proposal as a representative and operable means of reflecting transactions with its customers. Nevertheless, the revised ED will require CP entities to reconsider many of their accounting policies and practices. For example, the revised ED provides specific approaches to assessing variable consideration, which may affect an entity’s methods of accounting for customer incentives.
- In limited circumstances, the timing of revenue recognition could significantly change for CP entities. For example, entities that currently amortize minimum license fee revenue over the license term might instead be required to recognize those license fees up front. In addition, entities that currently defer revenues for goods shipped with “synthetic FOB destination” terms might instead be required to recognize some, but probably not all, revenue associated with those goods upon shipment.
- Given the significant concerns raised by certain industry groups in response to the revised ED, further changes to the proposed model are expected. CP entities are encouraged to monitor the boards’ redeliberation of the revised ED and consider how further changes to the proposed model will affect the industry. The boards are expected to issue a final standard in the first quarter of 2013.

# Beyond the Bottom Line

This *Consumer Products Spotlight* highlights the framework of the proposed revenue recognition model and the potential implications for CP entities that currently apply existing revenue recognition accounting standards under U.S. GAAP or IFRSs.

## Background

The revised ED states that the goal of the boards' revenue recognition project, which began in 2002, is to "clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRSs." After receiving nearly 1,000 comment letters and redeliberating almost every aspect of their June 2010 ED, the boards modified the proposed guidance and developed the revised ED (changes from the June 2010 ED are discussed in detail in Deloitte's November 15, 2011, *Heads Up*). The revised ED retained the overall model that was originally proposed, which outlined five sequential steps to recognizing revenue:

1. "Identify the contract with a customer."
2. "Identify the separate performance obligations in the contract."
3. "Determine the transaction price."
4. "Allocate the transaction price to the separate performance obligations in the contract."
5. "Recognize revenue when (or as) the entity satisfies a performance obligation."

The proposed model requires entities to reassess several aspects of their current revenue accounting and determine whether accounting changes are necessary.

The revised ED states that the core principle for revenue recognition is that an "entity shall recognize 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." Although the boards did not modify the five steps to applying this principle, they did change how each step is applied as well as other aspects of the proposed model. For instance, the proposal would require capitalization of certain costs of obtaining and fulfilling a contract and would modify the criteria for recognizing losses on certain onerous performance obligations.

Compared with current revenue recognition guidance, the revised ED requires 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, exercised in applying the proposal's provisions; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

## Key Accounting Issues

The revised ED clarifies the revenue recognition principles and includes additional guidance on certain revenue transactions. Although the revised ED may not significantly change the general revenue recognition model for normal product sales for CP entities, a number of the revised ED's proposals may differ from current practice. Discussed below are some key accounting issues that may significantly affect entities in the CP industry.

### Promotional Programs and Incentives

CP 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 proposed model, CP entities will need to assess (1) whether promotional programs are accounted for as a cost or a reduction of revenue, (2) the impact of sales incentives on the transaction price, and (3) whether an option for an additional good or service is a separate performance obligation.

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.

### ***Promotional Programs***

CP 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 revised ED provides guidance on determining when these benefits represent a separate good or service provided by the customer (i.e., a cost) versus an adjustment to the transaction price (i.e., a reduction of revenue). Specifically, the ED requires that the benefit received from a customer be treated as a cost only if it constitutes a distinct good or service. Under the proposed model, a good or service is distinct if either of the following criteria is met:

1. “The entity regularly sells the good or service separately.”
2. “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.”

Further, under the revised ED, the amount recognized as a cost 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 recognized as a reduction of revenue.

Although the revised ED (and companion proposed ASU issued by the FASB) will supersede certain industry-specific guidance in U.S. GAAP regarding the accounting for vendor allowances, the replacement of this guidance is not expected to significantly change the income statement characterization of many common types of allowances. However, CP entities will need to carefully examine the facts and circumstances of their promotional activities in the context of this more principles-based model.

### ***Sales Incentives***

Sales incentives, such as volume discounts, may create variability in the pricing of the goods or services offered to the customer. Under the revised ED, if the transaction price is subject to variability, an entity would be required to use an estimated transaction price based on either (1) the expected value (i.e., a probability-weighted amount) or (2) the most likely amount (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.” However, the amount ultimately recognized as revenue “shall not exceed the amount to which the entity is reasonably assured to be entitled.”

To use the expected-value technique, CP entities would need to estimate the transaction price in multiple scenarios. In making such estimates, entities would most likely have to use significant judgment; if there are material changes in estimates between reporting periods, financial statement volatility may result. The use of the most likely amount may be more predictive of the amount of consideration when there is a lack of information or a limited number of possible outcomes. However, in determining the most likely amount, CP entities would still need to exercise significant judgment and consider several key factors, such as the terms of the contract and the extent of their past experience with similar contracts.

### ***Options for Additional Goods or Services***

Under the revised ED, 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 otherwise would not have received without entering into the contract. If an incentive is deemed a separate performance obligation, an entity would allocate a portion of the transaction price, on a relative stand-alone selling price basis, to the incentive and recognize 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). For example, an entity may offer a discount on a future order if a customer currently purchases a certain quantity

of goods. A discount that gives the customer a “material right” would be treated as a separate performance obligation. That is, a portion of the consideration from the current transaction would be allocated to the material right (the option to purchase goods at a discount in the future) on the basis of its relative stand-alone selling price and would be recognized when the customer purchases the discounted goods.

CP entities may need to carefully assess how sales incentives that give customers the option to acquire additional goods or services affect the determination of performance obligations in a contract. This assessment is important because identification of additional performance obligations and the subsequent allocation of the transaction price may affect the timing of revenue recognized.

## Contract Costs

The revised ED requires capitalization of certain costs associated with obtaining a contract if those costs are incremental (e.g., sales commissions) and recoverable. In addition, the revised ED requires capitalization of certain costs of fulfilling a contract if all of the following criteria are met and the costs are not covered by other standards:

1. “The costs relate directly to a contract (or a specific anticipated contract).”
2. “The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.”
3. “The costs are expected to be recovered.”

Examples of such costs include direct labor and materials, depreciation of equipment used in fulfilling the contract, and subcontractor costs. As a practical expedient, certain costs of obtaining a contract can be expensed as incurred when the amortization period is one year or less.

Under the revised ED, capitalized contract costs should be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset relates and, in certain circumstances, may extend beyond the original contract term with the customer (e.g., when future anticipated contracts or expected renewal periods exist). The asset will be subject to impairment testing if any indicators of impairment exist.

Depending on how CP entities currently account for revenue-related costs, the proposed guidance may result in significant changes in practice and potentially require CP entities to capitalize costs they may have previously expensed. CP entities may want to closely evaluate the impact of the proposed guidance on their current accounting policies as well as whether they need to determine their accounting policy related to contract costs for short-term contracts with a duration of one year or less.

## Rights of Return

To ensure customer satisfaction, CP entities often grant customers the right to return a product. In a manner consistent with current practice, the revised ED allows entities to recognize revenue for goods subject to a right of return (the entity’s stand-ready obligation to accept returns is not deemed a separate performance obligation). However, the revised ED does require that an entity recognize separately in the balance sheet both a refund liability (for the amount expected to be refunded to the customer) and an asset (for the entity’s right to recover the product from the customer).

The revised ED’s guidance on accounting for a sale with a right of return is largely consistent with current practice under U.S. GAAP and IFRSs; however, entities will now be required to show on the balance sheet a liability for the refund obligation and an asset for the right to recover the product. In addition, entities will be required to subject the asset recognized to impairment testing if any indicators of impairment exist.

For products sold with a right of return, the revised ED proposes that an entity recognize a refund liability as well as an asset for the right to recover the product from a customer.

Revenue recognition is limited to the amount to which an entity is reasonably assured to be entitled.

## Warranties

CP entities often sell products with warranties assuring customers that the products will be free of defects at the time of sale and comply with agreed-upon specifications. In some cases, entities may also offer warranties that do more than simply assure the customer that the product complies with agreed-upon specifications (e.g., warranties that provide services for a fixed period after the initial warranty period has expired).

Under the revised ED, warranties would be accounted for as follows:

1. "If a customer has the option to purchase a warranty separately" from the entity, the entity "should account for the promised warranty as a separate performance obligation" and allocate a portion of the overall consideration to the warranty service.
2. "If a customer does not have the option to purchase a warranty separately" from the entity, the entity would use the cost accrual model to account for the warranty unless the warranty provides a service to the customer "in addition to the assurance that the product complies with agreed-upon specifications" (in which case the entity would account for the service as a separate performance obligation and revenue would be deferred).

The revised ED will not change the accounting for most warranties (i.e., typically warranties assuring the customer that the good or service complies with agreed-upon specifications), which are generally accounted for under a cost accrual model. However, CP entities may want to reassess all warranties offered to ensure that the warranties are not providing any services beyond assuring the customer that the product complies with agreed-upon specifications.

## Licenses and Rights to Use

The granting of licenses is common in the CP industry, since many products include a licensed image or brand name. The revised ED provides guidance on how an entity would account for the licensing of its intellectual property.

The revised ED states that for a contract in which an entity grants a license to a customer, the promised right or license gives rise to a performance obligation that the entity satisfies when the customer is able to use and benefit from the license (i.e., when the customer obtains control and the license term has commenced).

In addition, the revised ED imposes a constraint on the cumulative amount of revenue recognized, indicating that it "should not exceed the amount to which the entity is reasonably assured to be entitled." An entity can conclude that it is reasonably assured to be entitled to this amount when "the entity has experience with similar types of contracts and that experience is predictive of the amount of consideration to which the entity will be entitled."

However, the revised ED notes that in some circumstances, a customer may promise "to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service" (e.g., sales-based royalty), in which case the contract includes an amount of consideration that the entity "is not reasonably assured to be entitled to . . . until the uncertainty is resolved."

The proposed model may often require up-front recognition of license revenue, unless future revenues are subject to the reasonably assured constraint. Nonrefundable up-front license fees and future minimum license fees (not subject to sales indexing) would therefore be recognized as revenue at the beginning of the license term. Meanwhile, any sales-based royalty payments would not be recognized as revenue until the sales occur.

The revised ED requires significantly expanded disclosures, including any judgments applied by management.

### Example

An entity enters into a license agreement with a customer for five years. Under the agreement, the customer agrees to pay \$1 for each product it manufactures and sells by using the entity's intellectual property. When the entity satisfies its performance obligation by transferring the licensed intellectual property, it does not recognize revenue related to the future royalty payments until the uncertainty is resolved because the amount of the transaction price allocated to the performance obligation is not reasonably assured to be received (the customer can avoid paying an additional amount of consideration by not selling any products). The entity would recognize revenue for the \$1 royalty payment as the customer sells its products and the uncertainty is resolved. Although the entity may have experience with similar contracts, the revised ED states that with respect to sales-based royalties from licensing intellectual property, amounts are not reasonably assured until the customer's subsequent sale.

### Sell-Through Approach

CP entities often enter into arrangements in which they deliver products to another party (e.g., a dealer or distributor), who then sells the product to the end customer. Under the revised ED, CP entities will only be permitted to recognize revenue related to these arrangements when control of the products has been transferred. Depending on the terms of the arrangement, transfer of control may occur (1) at the time of transfer to the dealer or distributor or (2) when the product is eventually sold to the end customer.

CP entities will need to assess the terms of their arrangements with dealers and distributors to determine when a transfer of control occurs. This will include an assessment of indicators in addition to whether the risks and rewards of ownership have been transferred.

### Shipping Terms

CP entities may ship goods "FOB shipping point" but enter into arrangements with their customers under which the seller continues to bear risk of loss or damage 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. As a result, all risks and rewards of ownership have not been substantively transferred to the buyer and it would not be appropriate to recognize revenue before the goods are ultimately delivered to the buyer.

Under the revised ED, instead of all revenue being deferred, such an arrangement may give rise to two performance obligations: (1) to provide the customer with a product and (2) to cover the risk of loss during transit. In this case, the transaction price would need to be allocated to each performance obligation and the satisfaction of each performance obligation would be separately assessed. In effect, this may mean that revenue allocated to the product could be recognized as soon as the product is shipped, while the revenue allocated to the obligation to cover losses would only be recognized once the goods arrive at the customer's destination.

### Disclosures

The revised ED would require significantly more extensive disclosures than current revenue standards, including quantitative and qualitative information about contracts and the significant judgments used in applying the guidance to those contracts. Entities should consider how detailed their disclosures need to be to meet the requirements and how

To implement the revised ED's requirements, entities may need to gather new data and make changes to their systems, processes, and controls.

much emphasis to place on each disclosure requirement. The required disclosures would include:

- A disaggregation of reported revenue in the “primary categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.”
- A reconciliation of the beginning and ending balance of contract assets and liabilities.
- Certain information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about onerous obligations (extent and amount of such obligations, the reasons they became onerous, the expected timing to satisfy the liability, and reconciliation of onerous balances).
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition.
- Information about the methods, inputs, and assumptions used to determine the transaction price and allocate amounts to performance obligations.
- Information about assets recognized from costs to obtain or fulfill a contract, including a reconciliation of the beginning and ending assets (by main category of asset).

### Other

The revised ED provides guidance on many other topics that were not addressed above, including the identification and satisfaction of performance obligations, customer acceptance (e.g., if an entity delivers a product to a customer for a trial period and the customer is not committed to pay any consideration until the trial period lapses), principal-versus-agent considerations, bill-and-hold arrangements, collectibility, and onerous contracts. CP entities should carefully analyze the revised ED's guidance on these important topics to determine the significance to their financial reporting.

## Challenges for CP Entities

### Increased Use of Judgment

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

### Retrospective Application

The revised ED proposes retrospective application, with certain optional practical expedients available to entities at their discretion. This aspect of the proposal may require CP entities to gather data and assess contracts that commenced several years before the revised ED's effective date. CP entities also will most likely be required to perform dual tracking of revenue balances during this retrospective period, given the potential difficulty associated with retroactively recalculating revenue balances at the time the new standard becomes effective.

### Systems, Processes, and Controls

The revised ED proposes several new practices and disclosure requirements under which CP 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.

A final standard is not expected to be issued until the first quarter of 2013.

CP entities with large volumes of sales deals may find it operationally challenging to assess each sales deal to categorize and account for customer incentives in accordance with the revised ED; such entities may need to make substantial system modifications to facilitate this process.

CP entities may also recognize an asset for certain costs of obtaining or fulfilling a contract (unless the amortization period is one year or less and entities choose to recognize those costs as expenses immediately). CP entities may need to modify their current accounting practices and make appropriate system modifications to track data on contract duration, contract costs, and periodic amortization and impairment testing of capitalized costs.

Further, to ensure the effectiveness of internal controls over financial reporting, management will need to assess whether additional controls need to be implemented. CP 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 proposed rules.

Note that this section gives only a few examples of possible changes CP entities may need to make to their systems, processes, and controls; CP entities should evaluate all aspects of the revised ED's requirements to determine whether any other modifications may be necessary.

### **Income Taxes**

Tax departments need to assess changes in book revenue recognition methods to prepare for the tax effects. Federal income tax law contains specific rules on certain types of revenue, such as income from long-term contracts and advance payments for goods and services. Those rules often overlap with a taxpayer's financial reporting policies, in which case the taxpayer often applies, as its tax method, the revenue recognition method it uses in maintaining its books and records. Because the proposed guidance may change the amount and timing of revenue recognition for entities that maintain their books and records under U.S. GAAP or IFRSs, the accounting proposed in the revised ED may have cash tax implications or give rise to new book-tax differences that will need to be captured, calculated, and tracked through tax accounting processes and systems.

If a change in a tax accounting method is advantageous or expedient, including circumstances in which the book method has historically been used, the taxpayer will most likely be required to obtain approval from the relevant tax authorities. Similar implications may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs.

### **Thinking Ahead**

A final standard is not expected to be issued until the first quarter of 2013 and would be effective no earlier than for annual periods beginning on or after January 1, 2015 (with a minimum of a one-year deferral for nonpublic entities applying U.S. GAAP). CP entities should take advantage of this time to carefully examine the revised ED and begin assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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