



Revenue for retailers

The new standard's
effective date
is coming.

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Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount and

pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount, timing and presentation of revenue recognition.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

Read this to understand *some* of the most significant issues for retailers – the issues that you should be considering now.

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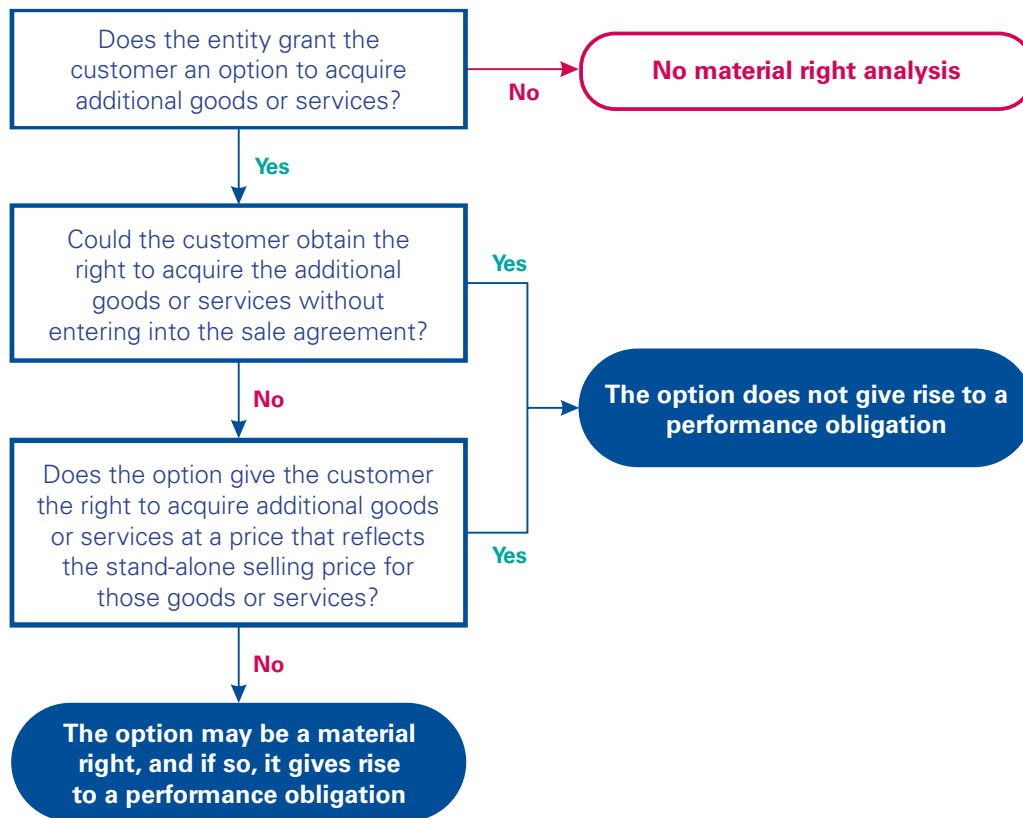
Sales incentives



Sales incentives that provide the customer with an option that is a material right result in revenue deferral until the option is exercised or expires.

Sales incentives offered by retailers can take different forms. Retailers very often provide free or discounted products through coupons, rebates or loyalty programs to customers to encourage the future sale of their products. Under current US GAAP, some retailers account for these incentives as expenses while others defer revenue. Under the new standard, these sales incentives are evaluated to determine whether they

provide the customer with an option that is a material right, which would be accounted for as a performance obligation. However, not all customer options are material rights. Rather, some options are simply marketing or promotional offers, which are accounted for separately from the contract with the customer – e.g. coupon drops that are available to all retail customers and not dependent on a prior sales transaction.



The option is a performance obligation (the unit of account for revenue recognition) under the contract if it provides a material right that the customer would not receive without entering into that contract. Retailers will need to evaluate and

update processes and internal controls for determining stand-alone selling prices for material rights used in allocating the transaction price to performance obligations.

Coupons and other sales discounts



Coupons and other sales discounts earned from current transactions may result in revenue deferral.

Applying the framework for sales incentives, a material right exists if:

- the coupon or other sales discount provides the customer with an option to purchase additional goods or services at a price that does not reflect their stand-alone selling prices; and
- those incentives are only earned as a result of the customer entering into the arrangement.

If a material right exists, it is accounted for as a separate performance obligation; this results in revenue being allocated to the option and deferred until the option is exercised or expires. The amount of revenue deferred is based on the relative stand-alone selling price of the customer's option to

acquire additional goods or services. If that price is not directly observable then the retailer needs to estimate it. This estimate reflects the discount that the customer would obtain when exercising the option, adjusted for:

- any discount the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

The assessment of whether a retailer has granted its customer a material right requires significant judgment. A material right does not exist if similar discounts are provided to customers in the same class regardless of whether they had qualifying prior purchases. However, a material right may exist even if it is not quantitatively material.

Example – Option that provides the customer with a material right

Retailer sells a computer to Customer for \$2,000. As part of this arrangement, Retailer gives Customer a voucher. The voucher entitles Customer to a 25% discount on any purchase up to \$1,000 in Retailer's store during the next 60 days. Retailer intends to offer a 10% discount on all sales to other customers during the next 60 days as its seasonal promotion. Retailer regularly sells this model of computer for \$2,000 without the voucher.

Retailer concludes that the discount voucher provides a material right that Customer would not receive without entering into the original sales transaction. This is because Customer receives a 15% incremental discount compared with the discount expected to be offered to other customers (25% discount voucher - 10% discount for all customers). Therefore, the discount voucher is a separate performance obligation.

Retailer estimates that there is an 80% likelihood that Customer will redeem the voucher and will purchase additional products with an undiscounted price of \$500.

Retailer allocates the transaction price between the computer and the voucher on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation	Calculation
Computer	\$2,000	97.1%	\$1,942	$\$2,000 \times 97.1\%$
Voucher	60 ¹	2.9%	58	$\$2,000 \times 2.9\%$
Total	\$2,060	100%	\$2,000	

Note:

1. Stand-alone selling price for the voucher: \$500 estimated purchase of products \times 15% incremental discount \times 80% likelihood of exercise.

Customer purchases \$200 of additional products (pre-discount) 30 days after the original purchase for \$150 cash payment. Customer makes no additional purchases before the expiration of the voucher. Therefore, at the expiration date Retailer recognizes the remaining amount allocated to the voucher as revenue.

Retailer records the following journal entries.

	Debit	Credit
Cash	\$2,000	
Revenue		\$1,942
Contract liability		\$58
<i>To record initial sale of computer and voucher.</i>		
Cash	\$150 ¹	
Contract liability	\$23 ²	
Revenue		\$173
<i>To record subsequent purchases by Customer.</i>		
Contract liability	\$35 ³	
Revenue		\$35
<i>To record additional revenue on expiration of voucher.</i>		
<p><i>Notes:</i></p> <p>1. Discounted sales prices of additional products purchased: \$200 - (\$200 × 25%).</p> <p>2. Partial satisfaction of performance obligation: \$58 × (\$200 purchases / \$500 total expected purchases).</p> <p>3. Settlement of performance obligation on expiration: \$58 - \$23.</p>		

If a tiered pricing structure provides for discounts on future purchases only after volume thresholds are met, it is likely that a material right has been conveyed to the customer. The retailer evaluates the arrangement to determine whether a material right exists.

Example – Buy four, get one free program

Retailer offers a program in which customers who have purchased four drinks over a given period may receive a fifth drink free. Based on its historical data, Retailer determines that it is likely that many of its customers will receive a free drink.

Customer purchases his first drink for \$10. The first purchase provides Customer with the right to purchase three more drinks and receive the fifth for free.

Retailer concludes that the option in the current transaction represents a material right. In making this determination, Retailer considers both current and future transactions, and concludes that Customer has in substance paid for one-fourth of a free drink in the current transaction (a 20% discount on five purchases).

This material right is accounted for as a separate performance obligation. This results in a portion of revenue from the sale of four beverages being allocated to the option to get a free beverage based on the stand-alone selling prices and deferred until the option is exercised or expires.

If a material right does not exist, there is no accounting for the future discount when recognizing revenue on the transactions completed. In that case, purchases after the threshold has been met are accounted for at the discounted price. When an option is independent of the current contract, the option is a marketing offer and not a material right. The fact that the retailer does not require customers in a similar class to earn the discount indicates that the discounted price does not represent a material right.

Example – Option that does not provide the customer with a material right

Retailer includes a coupon for 5% off purchases of a video game system within a sales circular that is available to all customers who walk through the door of the store. The coupon is valid for two weeks.

Customer A purchases a television and receives a 5%-off coupon generated by the register that can be used to purchase a video game system within two weeks. To evaluate whether this coupon provides Customer A with an option that is a material right, Retailer compares it to other discounts on a video game system offered to similar customers.

Customer B received the coupon from the sales circular when entering the store. Customer B then used the coupon to purchase a video game system at a 5% discount.

Customer C purchased a television and also received a similar register-generated coupon to purchase a video game system at a 5% discount.

The fact that Customer C receives the same discount as Customer A with its television purchase does not affect the analysis of whether a material right exists.

Retailer compares the coupon offered to Customer A to the discount offered to Customer B and notes that Customer B received the same discount without a prior purchase.

Therefore, the option to purchase the video game system at a 5% discount offered to Customer A does not provide a material right; it is not incremental to discounts offered to customers that did not make a previous purchase and Customer A could have received the discount without the purchase of the television. Therefore, the offer is independent of the purchase of the television and is a marketing offer.

Retailers often print coupons at the register after a purchase is completed – sometimes referred to as ‘Catalina coupons’ or ‘bounce-back coupons’ – that can be redeemed for a short period. The coupons are handed to customers at the point of sale, or packaged with goods that customers purchased.

Customers can often access similar discounts without making a purchase – e.g. if coupons are printed in a newspaper or are freely available in-store or online. This type of general marketing offer would indicate that the coupon does not provide a material right because the discount is available to the customer independent of a prior purchase.

If there is no general marketing offer, the entity assesses whether the coupon conveys a material right. This assessment includes consideration of the likelihood of redemption. A low redemption rate, which is typical for point-of-sale coupons, is a factor that suggests the coupon does not convey a material right or that the stand-alone selling price of the right is immaterial.

When the coupons are not deemed to convey a material right to the customer, they are recognized as a reduction in revenue on redemption. However, when there is no general marketing offer and the value of the coupon and likelihood of exercise is more significant, a material right could be conveyed. The fact that the discount is offered at a point of sale, though, is not determinative.

Retailers will need to evaluate and update their processes and internal controls for distinguishing coupons and other sales discounts that provide material rights from those that are marketing offers or that give rise to variable consideration (see [Payments to customers](#)).

Customer loyalty programs



Loyalty points represent a separate performance obligation, resulting in revenue being deferred until the awards are either redeemed or expire.

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 a good or service, a retailer provides award points that

can be accumulated and redeemed for free or discounted goods or services. Customer loyalty programs usually provide a customer with a material right that is a separate performance obligation.

Example – Customer loyalty points program

Retailer offers a customer loyalty program at its store. Under the program, customers are awarded one point for every \$10 they spend on goods. Each point is redeemable for a cash discount of \$1 on future purchases. Retailer expects 97% of customers' points to be redeemed. This estimate is based on Retailer's historical experience, which Retailer determines is predictive of the amount of consideration to which it will be entitled.

During Year 1, customers purchase products for \$100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is \$100,000.

The customer loyalty program provides the customers with a material right because the customers would not receive the discount on future purchases without making the original purchase. Additionally, the price that they will pay on exercise of the points on future purchases is not the stand-alone selling price of those items.

Because the points provide a material right to customers, Retailer concludes that the points are a performance obligation in each sales contract – e.g. the customers paid for the points when purchasing products. Retailer determines the stand-alone selling price of the loyalty points based on the likelihood of redemption.

Retailer allocates the transaction price between the products and the points on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation	Calculation
Products	\$100,000 ¹	91%	\$ 91,000	\$100,000 × 91%
Points	9,700 ²	9%	9,000	\$100,000 × 9%
Total	\$109,700	100%	\$100,000	

Notes:

- Stand-alone selling price for the products.
- Stand-alone selling price for the points: 10,000 points × \$1 × 97%.

Retailer recognizes a contract liability of \$9,000 for the amount allocated to the material right (points).

The following occurs in Years 2 and 3.

- During Year 2, 4,500 points are redeemed, and Retailer continues to expect that 9,700 points will be redeemed in total.
- During Year 3, a further 4,000 points are redeemed. Retailer updates its estimate because it now expects 9,900 rather than 9,700 points to be redeemed in total.

In Years 2 and 3, Retailer determines the revenue to be recognized as follows.

Calculation of cumulative revenue (Redeemed points / Total expected to be redeemed) × Allocation of revenue	Cumulative revenue	Revenue already recognized	Revenue to recognize this year
Year 2: (4,500 / 9,700) × \$9,000	\$4,175	0	\$4,175
Year 3: (8,500 / 9,900) × \$9,000	\$7,727	\$4,175	\$3,552

Revenue increases in Year 3 as a result of the redemption of an additional 4,000 points. However, revenue is also reduced because of the change in estimate of the total expected points to be redeemed. The change in estimate results in a cumulative adjustment to revenue regardless of whether points are redeemed.

Payments to customers – e.g. rebates, price protection and price matching programs



Retailers may reduce revenue for certain payments to customers earlier under the new standard.

Sales incentives offered in the form of rebates, price protection, price matching programs or allowances very often represent consideration payable to a customer. Under current US GAAP, consideration payable to a customer is recognized as a reduction to revenue at the later of when revenue is recognized or when an offer is made to a customer – which some have interpreted to be when an explicit offer is made to the customer.

Under the new standard, the payment to a customer is accounted for as a reduction in the transaction price, unless the payment is made for a distinct good or service (highly unusual in consumer retail transactions). The new standard includes guidance similar to current US GAAP that accounts for consideration payable to a customer at the later of when the related revenue is recognized or the retailer promises to pay such consideration.

However, under the new standard, retailers will more often account for these payments as variable consideration. This will require the retailer to estimate the consideration it expects to pay at contract inception, and to recognize the reduction of revenue as control of the goods or services are transferred.

This is because retailers typically have a past practice of providing these payments that, under the new standard, would not follow the 'later of' guidance. For example, the retailer evaluates whether it intends to provide an incentive or if the customer has a reasonable expectation that an incentive will be provided even though it may be in the form of consideration

payable to a customer. If yes, then the incentive is accounted for as variable consideration. If no, then the incentive is accounted for using the 'later of' guidance, which may be rare for retailers with a history of providing concessions or rebates. The retailer updates its estimate and adjusts revenue each reporting period.

Example – Price protection

Retailer sells a smart television to Customer for \$2,500 and also offers Customer a 'best price guarantee' wherein it agrees to reimburse Customer for the difference between the price Customer paid and the price offered by Retailer or any of its competitors for two months following the sale.

Retailer estimates the transaction price and concludes based on its prior experience with similar promotions and products that it will reimburse Customer \$50. Consideration expected to be repaid to Customer is variable consideration; it reduces the transaction price and revenue, and is recorded as a liability at the time of sale.

If Retailer did not explicitly make the guarantee to Customer (e.g. no explicitly stated policy or stated on the customer's receipt), but often provides similar guarantees, that past practice would cause Retailer to account for the guarantee in the same manner as if it had been explicitly promised.

Rights of return



The balance sheet will be grossed up to present a refund liability and an asset for recovery, and return estimates and their balance sheet presentation may change.

Under current US GAAP, revenue is recognized on product sales with a right of return when certain conditions are met, including the ability to reasonably estimate future returns. On rare occasions when the retailer is unable to reasonably estimate returns (e.g. on entering a new market with no previous sales history), it may be required to defer revenue under current US GAAP. Exchanges by customers of one product for another of the same type, quality, condition and price are not considered returns under current US GAAP (or the new standard).

The new standard requires an entity to estimate returns and evaluate the constraint on variable consideration in determining the amount of revenue to recognize. This approach of adjusting revenue for the expected level of returns and recognizing a refund liability is broadly similar to current guidance, but some aspects of the new standard may result in changes to current practice.

Estimation methodology

Under the new standard, an entity estimates sales returns using either the expected-value method (e.g. probability-weighted estimates) or the most-likely-amount method. The method selected depends on which is the better predictor; the expected-value method is generally more predictive for sales returns.

Estimated returns could result in amounts similar to current practice in many cases, but the estimation method could be different if an entity currently uses a single best estimate approach rather than an expected-value method like a probability-weighted assessment or more sophisticated modeling.

After estimating returns, an entity applies the constraint on variable consideration, which limits revenue recognition to an amount that is probable of not having a significant reversal in the future. The constraint guidance is intended to ensure that

adjustments to previously constrained product or services revenue generally are only upward (increases to revenue). Because current US GAAP only requires future returns to be reasonably estimable, entities often record upward or downward adjustments to revenue as a result of the right of return guidance. Retailers with a history of significant downward adjustments to revenue may defer more revenue for estimated returns under the new standard.

When reasonable estimates cannot be made

Under the new standard, most entities will have sufficient information to recognize consideration for an amount greater than zero, even when they lack historical experience on which to base their returns estimate. Applying the constraint on variable consideration does not result in defaulting to zero revenue recognition (as happens under current US GAAP when a reasonable estimate cannot be made).

This means that retailers will estimate some minimum amount of revenue that is probable of not resulting in a significant reversal, resulting in revenue being recognized before the return period lapses. Estimates are updated each reporting period.

Presentation

Under the new standard, the return is presented gross as a refund liability and an asset for recovery. This will be a change in practice for many retailers that currently present reserves or allowances for returns on a net basis. The asset for recovery is reported separately from inventory and, when impaired, reduced to the merchandise value the retailer expects to recover through subsequent sales or a return to the consumer products vendor. Retailers will record any expected diminished merchandise value as cost of sales each reporting period. The refund liability and right-to-recover asset are also adjusted at each reporting period for changes in estimated returns.

Example – Sales with a right of return

Retailer sells 100 pairs of shoes at a price of \$100 each and receives payments of \$10,000. The terms presented on the sales receipts allow customers to return any undamaged merchandise within 30 days and receive a full refund in cash or store credit. The cost of each product is \$60. Retailer estimates that three pairs of shoes will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

Retailer estimates that the costs of recovering the merchandise will not be significant and expects that the shoes can be resold at a profit or returned to the shoe vendor for full credit. Within 30 days, two pairs of shoes are returned.

Retailer records the following journal entries.

	Debit	Credit
Cash	\$10,000	
Refund liability		\$300 ¹
Revenue		\$9,700
<i>To record sale excluding revenue on products expected to be returned.</i>		
Asset (right to recover)	\$180 ²	
Cost of goods sold	\$5,820	
Inventory		\$6,000
<i>To record COGS and right to recover products from customers.</i>		
Two products returned		
Refund liability	\$200 ³	
Cash		\$200
<i>To record refund for product returned.</i>		
Inventory	\$120 ⁴	
Asset (right to recover)		\$120
<i>To record product returned as inventory.</i>		
Right of return expires		
Refund liability	\$100	
Revenue		\$100
<i>To record revenue on expiration of right of return.</i>		
Cost of goods sold	\$60	
Asset (right to recover)		\$60
<i>To record COGS on expiration of right to recover products from customers.</i>		
Notes:		
1. $\$100 \times 3$ (price of the products expected to be returned).		
2. $\$60 \times 3$ (cost of the products expected to be returned).		
3. $\$100 \times 2$ (price of the products returned).		
4. $\$60 \times 2$ (cost of the products returned).		

Restocking fees

Retailers sometimes charge a customer a restocking fee when a product is returned. The restocking fee is intended to compensate the retailer for costs associated with a product return or the reduced selling price a retailer may charge when reselling the product to another customer.

A right of return with a restocking fee is similar to a right of return for a partial refund. Therefore, restocking fees for products expected to be returned are included in (and therefore

reduce) the estimated refund liability when the product is sold. The refund liability is based on estimated returns less the restocking fee. Any costs related to restocking are reflected as a reduction in the carrying amount of the asset recorded for the right to recover those products.

There is mixed practice in accounting for restocking fees under current US GAAP with some retailers recognizing restocking fees when they are collected. Therefore, this may represent a change for some retailers.

Example – Restocking fees

Retailer sells 20 pieces of furniture for \$300 each and the cost of each piece of furniture is \$160. Customers have the right to return the furniture, but they are charged a 10% restocking fee. Retailer expects to incur restocking costs of \$20 per piece of furniture returned, and estimates returns to be 5%. The furniture is expected to be in saleable condition upon return.

When control of the furniture transfers to a customer, Retailer recognizes the following.

Item	What to include	Amount	Calculation
Revenue	Furniture estimated not to be returned plus restocking fee	\$5,730	$(19^1 \times \$300) + (1 \times \$30^2)$
Refund liability	Furniture expected to be returned less restocking fee	270	$(1 \times \$300) - \30^2
Asset for recovery	Cost of furniture expected to be returned less restocking cost	140	$(1 \times \$160) - \20

Notes:

1. Furniture not expected to be returned: 20 pieces of furniture sold less one $(20 \times 5\%)$ expected to be returned.
2. Restocking fee: $\$300 \times 10\%$.

Retailer records the following journal entries.

	Debit	Credit
Cash	\$6,000	
Refund liability		\$270
Revenue		\$5,730
<i>To record sale excluding revenue on products expected to be returned.</i>		
Asset (right to recover)	\$140	
Cost of goods sold	\$3,060	
Inventory		\$3,200
<i>To record COGS and right to recover products from customers.</i>		

Timing of revenue



Retailers may experience a change in the timing of revenue recognition for certain types of arrangements.

Under current US GAAP, retailers recognize revenue when the risks and rewards have transferred to the customer, which is generally at the point in time that goods are delivered to the customer. Most in-store transactions will continue to be recognized at point-of-sale under the new standard. However, in certain fact patterns (e.g. customer online purchases), revenue satisfied at a point in time could be recognized at a different point than under current US GAAP.

The new standard is a control-based model that takes an approach to revenue recognition that is conceptually different from current US GAAP. Under the new standard, revenue is recognized when the customer obtains control of the good or service. Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

The notion of risks and rewards is only one of the indicators of control. Other indicators such as legal title, physical possession, right to payment and customer acceptance also need to be evaluated for each arrangement. It is important for retailers to consider whether it or the customer controls the goods during shipment, and that consideration is affected by the rights and obligations during shipping.

Retailers may have arrangements in which the goods are shipped to the customer FOB shipping point. Under current US GAAP, these terms may be treated as FOB destination arrangements (revenue is deferred until goods are received by the customer) because the retailer assumes the risk of loss during transit and has determined that the risks and rewards of the goods do not pass to the customer at the shipping point. This is often referred to as 'synthetic FOB destination'.

Because the transfer of the risks and rewards of the asset is only one of the indicators for determining when the customer obtains control of the goods, there will likely be many cases under the new standard in which retailers determine that control of the goods in these types of arrangements transfers when the goods are shipped despite the retailer's practice of assuming the risk of loss during transit.

Shipping and handling services

The accounting for shipping and handling activities under the new standard depends on whether the activities are performed before or after the customer obtains control of the goods.

- If the shipping and handling occur *before* the customer obtains control of the goods, they are fulfillment activities.
- If the shipping and handling occur *after* a customer obtains control of the goods, an entity makes a policy election (and discloses its election) to treat these activities as:
 - fulfillment activities, in which case the entity accrues the costs of these activities and recognizes revenue and costs at the point in time that control of the goods transfers to the customer – thereby achieving matching of the expense and revenue; or
 - a performance obligation, in which case the entity allocates a portion of the transaction price to the shipping and handling. Revenue allocated to the goods is recognized *when* control of the goods transfers to the customer, and revenue for the shipping is recognized *as* the shipping and handling performance obligation is satisfied. The related costs are generally expensed as incurred.

Regardless of which policy a retailer uses, when it concludes that control transfers to the customer (e.g. at shipping point) before all of the significant risks and rewards of ownership have been transferred, it may experience a change in practice if it currently applies synthetic FOB destination accounting.

Current US GAAP allows for diversity in the income statement presentation of shipping and handling services. Entities may record these activities in costs of goods sold or another financial statement line item (e.g. SG&A). If these costs are significant and not recorded in costs of goods sold, current US GAAP requires them to be disclosed.

The new revenue standard does not explicitly address the presentation of these costs. Classifying these activities as cost of goods sold because they are considered fulfillment activities would be an acceptable presentation.

Based on discussions with the SEC, it would also be acceptable for an entity to continue its current presentation or to change its classification to cost of goods sold. However, it would not be appropriate to change from a current presentation of cost of goods sold to another financial statement line item.

In addition, entities are encouraged to continue to provide disclosure about these costs and where they are presented in the income statement.

Principal vs. agent

Certain retailer arrangements like flash title and drop shipments require significant judgment to determine whether the retailer is the principal or agent.

Under the new standard when other parties are involved in providing goods or services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services themselves, or to arrange for them to be provided by another party – e.g. whether it is a principal or an agent.

This determination is made by identifying each good or service promised to the customer in the contract and evaluating whether the entity obtains control of the specified good or service *before* it is transferred to the customer, considering the new overarching control principle. 'Control' is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services (or prevent others from doing so). An entity cannot provide a specified good or service if it does not first have control of that good or service.

In addition to the new overarching principle of control, the new standard provides indicators to assist with the evaluation of whether the entity controls the good or service *before* it is transferred to the customer and is therefore a principal in the transaction: (1) the entity is primarily responsible for fulfilling the promise to provide the specified good or service; (2) the entity has inventory risk before the specified good or service has been transferred to the customer or after transfer of control to the customer; and (3) the entity has discretion in establishing the price for the specified good or service. These indicators may provide relevant evidence in the evaluation of the control principle – i.e. whether the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service. Both the control principle as well as relevant information provided by the control indicators are considered when evaluating the substance of the transaction.

Because the principal versus agent evaluation in the new standard is based on the concept of control of the specified good or service, some of the indicators used in current US GAAP for assessing whether a party is a principal or an agent are not included in the new standard – i.e. exposure to physical loss inventory risk, whether the entity's fee is fixed or in the form of a commission, and exposure to customer credit risk. Also, the new standard does not specify any of the indicators as being more important than others, whereas current US GAAP specifies that being the primary obligor and having general inventory risk are stronger indicators that the intermediary is a principal.

Because an entity evaluates whether it is a principal or an agent for each specified good or service to be transferred to the customer, it is possible for the entity to be a principal for one or more goods or services and an agent for others in the same contract. This could affect the allocation of revenue to the distinct goods or services within the contract.

As a result of the changes to the principal versus agent guidance introduced by the new standard, retailers need to reconsider their conclusions, which could result in changes to current accounting.

Retailers enter into a variety of arrangements where assessment of control of a specified good or service may be challenging. For example, significant judgment is required in the principal-agent assessment for flash title, drop shipping and vendor-managed inventory arrangements.

Flash title

Flash title arrangements are those in which the retailer does not take title to the goods or services until the point of sale to a customer, and the end customer immediately takes control after that. Although taking title may indicate that the retailer can direct the use of and obtain substantially all of the remaining benefits of the good, it is not determinative that control has transferred. For example, taking title to a good only momentarily at check-out scanning before transferring title to the customer does not in and of itself mean a retailer controls the specified good or service before it is transferred to the customer. In contrast, a retailer could control a good before obtaining title.

When a retailer obtains only flash title to the specified good, we believe the principal-agent evaluation should focus on whether it obtains controls of the specified good or service before obtaining flash title, and a consideration of the retailer's and supplier's rights before transfer of the good to the end customer.

The following are likely key factors to consider in many circumstances:

- Whether the retailer has physical possession of the goods (one of the point-in-time indicators providing relevant evidence) and could direct the use of the products in the same way it could direct the use of the products for which it had title before a customer purchasing the product at the register. For example, the retailer could decide in which store or in which part of its store the products are placed and what price is charged, or it could control access to the products through its operation of the store.

- Whether the retailer has the ability to obtain substantially all of the benefits from the products in the form of the cash flows from the sale to the customer.
- Whether the supplier can constrain the retailer's ability through call rights or other provisions to direct the use of and obtain substantially all of the remaining benefits from the products.

Drop shipment arrangements

In drop shipment arrangements, the retailer often does not take physical possession of the specified good before control of that good is transferred to the customer. However, because 'control' refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, a good or service (including the ability to prevent others from doing so), physical possession is not always required to have control; similarly, momentary physical possession does not necessarily convey control. The lack of physical control makes the principal versus agent analysis more challenging in drop shipment scenarios.

Control of a tangible good frequently goes hand-in-hand with having front-end inventory risk with respect to the good. This would occur when, for example, the retailer:

- maintains an inventory of the good that is being drop shipped in the contract;
- has the right to sell (or use, lease, etc.) and an obligation to formally purchase (or make payment for, etc.) the good before the customer places its order with the retailer; and/or
- has an enforceable purchase commitment for the good with the supplier before the customer's order.

Many retailers may not have the front-end inventory risk evidenced by the above indicators. Also, obtaining title (e.g. during a short period of transit), or where that title is 'limited' in terms of *not* conveying the right to redirect or resell the good to another customer, would not alone convey control. Similarly, obtaining title only after a customer returns the good does not necessarily mean the retailer controls the specified good *before* it is transferred to the customer. Despite the absence of front-end inventory risk, control of the specified good may reside with the retailer when the retailer has the ability to direct (e.g. sell, use or lease) the specified good as it sees fit and the right to obtain substantially all of its remaining benefits (e.g. in the form of cash from sale, or consumption of the good in use) and can, as a result, effectively prevent the third-party vendor from exercising similar rights.

The new standard also suggests that an entity may be a principal – i.e. deemed to control a specified good or service – if another party (e.g. a third-party vendor) is, in its role, effectively acting on behalf of the entity. This may be the case, for example, when an entity obtains a contract with a customer

and then engages a subcontractor to fulfill its performance obligation. The following indicators may, depending on the facts and circumstances, suggest that the third-party vendor in a drop ship arrangement is acting on behalf of the retailer; these factors are not exhaustive, and no one factor should be considered necessarily determinative.

- The third-party vendor is 'invisible' to the customer – i.e. the customer is unaware of who the supplier of the specified good is before it obtains control of the good.
- The vendor packages the specified good as coming from the retailer – e.g. in the retailer's box and other packaging.
- The vendor is obligated to maintain an inventory of the specified good that it is not permitted to sell, use or otherwise direct for a purpose other than shipment to the retailer's customers (when ordered) – i.e. in this case, the vendor may essentially be holding inventory for the retailer.
- The retailer has the right and ability to source the specified good from more than one supplier after the customer places its order with the retailer.

A retailer should also consider the indicators of control that are provided in the new standard when assessing whether the vendor in a drop shipment arrangement is effectively acting on the retailer's behalf. The following indicators generally provide more relevant evidence.

- **Primary responsibility for fulfillment.** Is the retailer or the third-party vendor primarily responsible for fulfillment of the customer order? What is the retailer's responsibility for fulfillment and product acceptability as compared to the vendor's?
- **Inventory risk.** Does the retailer have front-end inventory risk with respect to the third-party goods? Does the retailer have back-end inventory risk (i.e. does it bear the risk of loss or damage and/or return risk)? If so, how significant is the back-end inventory risk? Are any of those risks mitigated by the third-party vendor arrangements – e.g. ability to return items to the vendor and/or return terms with customers that permit the retailer to refuse returns that will not in turn be accepted by the vendor?
- **Pricing discretion.** What is the degree of the retailer's discretion in establishing the price to the customer?

The new standard notes that pricing discretion may also be present when an entity is an agent and therefore may have a more limited effect on the assessment of control in these arrangements.

An evaluation of the specific rights and obligations in each customer and vendor relationship may be required because these arrangements can vary by customer, third-party vendor and specified good.

Gift cards



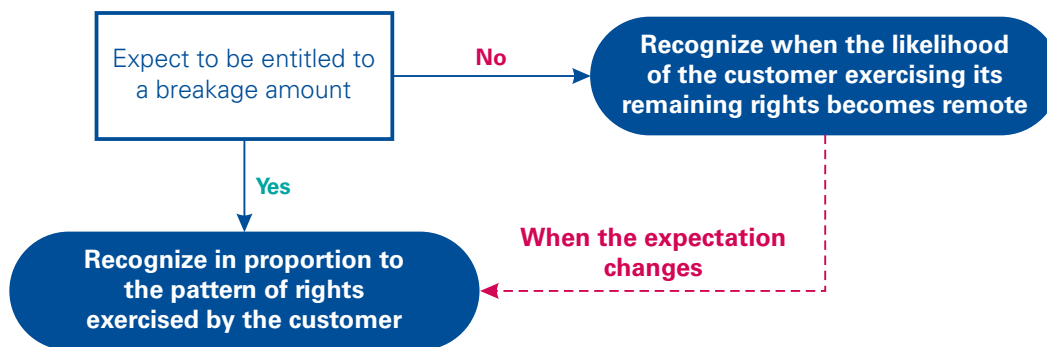
Breakage revenue is recognized in proportion to the pattern of redemption by the customer when the retailer expects to be entitled to breakage.

Gift cards (or certificates) sold by retailers are often not redeemed for their full value by the customer. The portion of a customer's rights that are unexercised (i.e. the unredeemed value) is referred to as breakage. For example, if a retailer expects a customer will redeem only 90% of the value of a gift card, 10% of the amount paid for the gift card is breakage. In this instance, the customer is expected to let its right to obtain goods or services for 10% of its prepayment expire or remain unexercised.

There is diversity in the current accounting for breakage with three acceptable methods to recognize breakage revenue: (1) as the entity 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. In addition, there is current diversity in practice in how breakage is presented in the income statement – as revenue, other income, or in some cases as an offset to expense.

Under the new standard, the timing of breakage revenue recognition depends on whether the entity expects to be entitled to a breakage amount – e.g. if it is probable that recognizing breakage will not result in a significant reversal of the cumulative revenue recognized.



A retailer considers the variable consideration guidance to determine whether – and to what extent – it expects to be entitled to a breakage amount. Under these principles, a retailer assesses whether it is probable that recognizing revenue on a proportionate basis for the unexercised rights (the recognition model required if a breakage estimate can be made) will not result in a significant revenue reversal in the future. Retailers with established gift card programs will consider historical customer redemption data and likely conclude there is an expectation of being entitled to some amount of revenue that is not probable of significant reversal.

A gift card that is issued by an entity and gives the customer rights to its goods and services is in the scope of the new standard. The standard requires an entity to determine whether it expects to be entitled to a breakage amount and, if so, to recognize the breakage amount in proportion to customer redemptions of the gift cards. Because the methods used in current GAAP are accounting policies, rather than an analysis of the entity's specific facts and circumstances, some retailers using either of the first two methods may be required to recognize breakage revenue sooner than under

their current accounting policy election. Additionally, under the new standard retailers will present breakage as revenue in the income statement.

If a retailer does not have a basis for estimating breakage, it will likely conclude that any estimate is fully constrained because it is unable to conclude that breakage is expected. In that case, revenue is recognized when the likelihood of the customer redeeming the balance becomes remote (remote method).

A retailer updates its analysis of estimated breakage each reporting period, including whether the expectation of breakage has changed and the appropriateness of its use of the remote method. If changes in the estimate arise, the entity adjusts the contract liability to reflect the remaining pattern of redemption expected.

If the retailer is required to remit to a government entity the amount that is attributable to customers' unexercised rights – e.g. under applicable unclaimed property or escheatment laws – then it recognizes a financial liability until the rights are extinguished, rather than recognizing the breakage amount as revenue.

Example – Sale of a gift card – Retailer expects to be entitled to breakage

Retailer sells a nonrefundable gift card to Customer for \$100.

On the basis of historical experience with similar gift cards, Retailer estimates that 10% of the gift card balance will remain unredeemed, and that unredeemed amount will not be subject to escheatment (i.e. unclaimed property laws).

Because Retailer can reasonably estimate the amount of breakage expected, and it is probable a significant revenue reversal will not occur if it recognizes breakage on a proportional basis, Retailer recognizes the breakage revenue of \$10 in proportion to the pattern of exercise of Customer's rights.

Specifically, when it sells the gift card, Retailer recognizes a contract liability of \$100 because Customer prepaid for a nonrefundable card. No breakage revenue is recognized at this time.

If Customer redeems \$45 of the gift card amount in 30 days, then half of the expected redemption has occurred ($[\$45 / (\$100 - \$10)] = 50\%$). Therefore, half of the breakage – i.e. \$5 ($\$10 \times 50\%$) – is also recognized.

Accordingly, on this initial gift card redemption, Retailer recognizes revenue of \$50: \$45 from transferring goods or services, plus breakage of \$5.

Example – Sale of a gift card – Retailer does not expect to be entitled to breakage

Retailer implements a new gift card program in a new market. Retailer sells Customer a nonrefundable gift card for \$50. Retailer does not have an obligation to remit the value of unredeemed cards to any government authority or other entity. The gift card expires five years from the date of issue.

Because this is a new program, Retailer has very little historical information about customer redemption patterns and breakage. Specifically, Retailer does not have sufficient entity-specific information, nor does it have knowledge of the experience of other retailers in the market to estimate breakage. Therefore, Retailer concludes that it does not have a basis to conclude that it is expected to be entitled to breakage in an amount that if recognized would be probable of not resulting in a significant revenue reversal.

Retailer therefore recognizes the breakage when the likelihood of Customer exercising its remaining rights becomes remote. This may occur on expiration of the gift card, or earlier if there is evidence to indicate that the probability has become remote that Customer will redeem any remaining amount on the gift card.

However, Retailer will continue to evaluate its information about breakage prior to Customer's exercise becoming remote. If it subsequently obtains sufficient evidence to support an estimate of breakage, it will begin recognizing breakage on a proportional basis. Retailer will also make a cumulative catch-up adjustment to revenue in the period that it concludes it has sufficient information about breakage.

Credit card arrangements

Retailers' credit card arrangements may be complex and require significant judgment and analysis to determine the appropriate accounting.

Some retailers enter into co-branded credit card arrangements with a credit card issuer (typically a financial institution). Credit card issuers enter into these arrangements with retailers principally to increase the number of cardholders and drive additional credit card revenue (e.g. interest income, interchange fees) by incentivizing card spend with retailer loyalty points and/or free or discounted goods and services.

Under these arrangements, the retailer may receive a variety of payments from the card issuer: up-front, nonrefundable payment, card acquisition bounties for each new card, card portfolio revenue or profit share, and payments for marketing activities, loyalty points or other customer services (e.g. free shipping or delivery to cardholders).

Retailers determine whether these arrangements are in the scope of the new standard by evaluating whether the services being provided are part of the retailer's ordinary activities. The new standard does not define ordinary activities, but refers to the definition of revenue in the FASB Concepts Statements. The definition of revenue is based on how the entity attempts to fulfill its basic function in the economy of producing and distributing goods or services at prices that enable it to pay for the goods and services it uses and to provide a return to its owners. Although the payments in these arrangements are received from card issuers rather than the retail customer, the arrangements are common in the industry and are used by retailers as a vehicle to increase customer spend in their stores and expand brand loyalty or recognition. Therefore, co-brand cards are typically part of the underlying retail business to help the retailer drive sales within their core business and generally these arrangements are in the scope of the new revenue standard for the retailer.

Performance obligations

A typical credit card arrangement may include the following elements:

- license to use retailer's brand name;
- license to use retailer's customer relationship/list;
- marketing activities;
- card acquisition services;
- retailer's customer loyalty program points; and/or
- other services provided to cardholders – e.g. extended maintenance, free shipping/delivery.

The promises in the contract are evaluated to determine if they are distinct and therefore represent performance obligations that are separate units of account.

Licenses for brand names and customer relationships are considered symbolic intellectual property (IP) under the new standard because the utility of the license largely depends on the entity continuing to support or maintain that IP. Therefore, a license to symbolic IP grants the customer a right to access the entity's IP, which is satisfied over time.

Marketing-related activities are evaluated to determine if they are promises distinct from the licensed IP. Many marketing activities may support or maintain the licensed IP and therefore are not distinct, while others may transfer a separate promise to the card issuer. Retailers may also provide card acquisition services to the card issuer whereby they assist in the referral and credit card application process. Retailers may receive 'bounties' (contingent payments) based on the number of cards that are signed up.

Loyalty program points that are purchased by the card issuing bank based on cardholder spend will generally be recognized following the accounting for loyalty points for retail customers (see [Customer loyalty programs](#)). However, there may be arrangements where the card issuer purchases points from the retailer up-front or in bulk purchases, often to be used in promotional activities to attract or reward cardholders. In these scenarios, the retailer evaluates when control of the right transfers to the card issuer and whether a significant financing component exists that could result in the recognition of interest expense (see [Customer financing](#)).

Retailers evaluate the various benefits and services provided to retail customers on behalf of the card issuer (card issuer funds the services for their cardholders) to determine whether these benefits are optional purchases (and follow the material rights guidance) or represent variable consideration for a promise to stand ready to provide those services.

Allocating the transaction price

Under the new standard, the transaction price (both fixed and variable consideration) is allocated to the performance obligations in a contract based on their relative stand-alone selling prices. Variable consideration is generally required to be estimated (see [Step 3](#)) but certain exceptions exist. Given the various fixed and variable revenue streams in these contracts, applying the allocation guidance may be challenging.

Direct allocation of variable consideration

One exception to estimating variable consideration is for variable consideration that is attributable to one or more, but not all, performance obligations because (1) the terms of the variable payment relate specifically to the entity's efforts to

satisfy the performance obligation or transfer the distinct goods or services, and (2) allocation of the variable payment entirely to one or more, but not all, of the performance obligations results in allocation that is consistent with the overall allocation objective of the standard.

This analysis requires significant judgment and an evaluation of all of the performance obligations and payment streams (fixed and variable) in the contract. If this guidance is met, the variable payment is recognized when control of the related good or service is transferred to the customer.

Sales- or usage-based royalty exception

Another exception to estimating variable consideration is for sales-based royalties related to licenses of IP. A card revenue share or payments based on card spend (e.g. certain loyalty point purchases) that are provided in these arrangements may serve as a sales- and usage-based royalty related to the symbolic IP (brand name and customer relationship).

The sales-based royalty exception applies either when the royalties relate only to a distinct license of IP or when the license is the predominant item to which the royalty relates.

When the license is not the only good or service in the arrangement (which is typically the case), the retailer evaluates whether the license(s) is the predominant item to which the royalty relates. The royalty to be evaluated could be a revenue share or it could be payments that are based on card spend (e.g. certain loyalty point purchases) when those payments relate to more than points purchases. The license would be the predominant item if the card issuer would ascribe significantly more value to the brand and customer relationship licenses than to the loyalty points or other goods or services to which the revenue share or payments relate. In this case, the exception would still apply to the entire sales-based royalty.

For sales-based royalties, a retailer recognizes revenue at the later of:

- when the subsequent sales occur; or
- on the satisfaction or partial satisfaction of the performance obligation to which the royalty relates.

To the extent that the royalty exception applies, the revenue share is recognized as the underlying card swipe occurs. However, exceptions may arise if the revenue share is also promised in exchange for other goods or services, or if the royalty does not reflect performance (e.g. certain tiered royalties). In addition, any guaranteed royalties (e.g. a fixed minimum amount) are accounted for as fixed consideration.

When the revenue share or the loyalty point purchase covers both the license and the loyalty point, the retailer determines the relative stand-alone selling price of the point and the license. The value of the points purchased by the card issuer would generally be included in the retailer's loyalty point deferral accounting. If the revenue share or loyalty point purchase also compensates the retailer for other services (e.g. extended return policies, free shipping, discounts, marketing services) but the license remains the predominant

item to which the royalty relates, the retailer is required to allocate revenue to those underlying services.

The retailer evaluates the timing of when the underlying services are provided to determine when it is appropriate to recognize that allocated portion of the royalty. For example, if the retailer transfers up-front goods or services distinct from the license of IP, the amount of revenue allocated to the up-front performance obligations is initially limited until the subsequent sales (card swipes) occur. However, if the retailer transfers goods or services distinct from the license later in the contract, those performance obligations may be satisfied after the sales-based royalty being earned. This situation may require that a portion of the sales-based royalty be deferred and recognized when control of the distinct performance obligation is transferred.

Conversely, if the royalty exception does not apply, the retailer may need to estimate the variable consideration and include it in the initial determination of the transaction price to be allocated to all the performance obligations unless the variable payments can be accounted for using the direct allocation guidance (see [Direct allocation of variable consideration](#)).

Revenue share reporting on a lag is not permissible

Under current US GAAP, some retailers recognize the revenue share on a lag basis – i.e. they recognize revenue in the period subsequent to that in which the card purchases occur. This is because they do not receive reporting about the revenue share that the card issuing bank owes until the subsequent period.

Under the new standard, recognition based on lag reporting is not permitted. If the underlying card spend is not known at the reporting period close, the spend needs to be estimated using a most-likely-amount or expected-value method; that amount is recognized as revenue for the period. The retailer trues up the difference between the estimate and actual revenue share earned in the subsequent period.

Credit card processing

Retailers enter into arrangements with banks and card processors to facilitate credit and debit card transactions within their stores. These are generally entered into with different entities and/or separately from any co-brand credit card arrangement. However, in some cases the co-brand credit card arrangement may also include pricing related to these processing fees, which may require additional transaction price allocation considerations. Currently there is diversity in the presentation of card processing fees, with some retailers recording these fees net against the retail sale.

Under the new standard, transaction price excludes amounts collected on behalf of third parties. When these card processing fees are not charged to the customer or paid on behalf of the customer, the retailer bears the cost associated with the card processing. In these cases, these costs would not represent a reduction in transaction price (i.e. retail sale). This may result in more retailers recording card processing fees as an expense.

Customer financing



The amount of revenue recognized by retailers may be affected by financing offered to customers.

Retailers sometimes offer promotional incentives that allow customers to buy items such as furniture and pay the cash selling price after delivery in installments or in a deferred lump-sum payment. Under current US GAAP, extended payment terms may result in a conclusion that revenue is not fixed or determinable, which precludes revenue recognition. In those cases, retailers may default to a due-and-payable revenue model and not account for a financing element.

Under the new standard, when the retailer concludes that it is probable it will collect the amount to which it expects to be entitled, it evaluates whether its contractual arrangement with the customer contains a significant financing component. If the period between performance and the related payment is more than one year, a significant financing component may exist in the arrangement.

As a result, the accounting for financing in arrangements where the customer pays in arrears will likely arise more frequently. This accounting results in a decrease in revenue and an increase in interest income as compared to similar arrangements under current US GAAP. Although not as common for retailers, advance payments from customers may also result in accounting for a significant financing component, increasing revenue and increasing interest expense. However, the new standard provides a practical expedient, whereby an entity is not required to account for the significant financing component if it expects that the period between when it transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less.

A financing component may be explicitly identified in the contract or may be implied by the contract's payment terms. Generally, the objective of a significant financing component

is to recognize revenue at an amount that reflects what the selling price of the promised good or service would have been if the customer had paid cash at the same time as control of that good or service transferred to the customer.

However, a significant financing component may still exist when the consideration to be received for a good or service with extended payment terms is the same as the cash selling price and the interest rate is zero. Judgment is required to evaluate whether in these circumstances an entity is offering a discount or other promotional incentive (variable consideration) for customers who pay the cash selling price at the end of the promotional period equal to the financing charge that would otherwise have been charged in exchange for financing the purchase.

If the retailer concludes that significant financing has been provided to the customer, then the transaction price is reduced by the implicit financing amount and interest income is accreted. Even when an interest rate is charged to the customer, it may not always be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer 'cheap' financing as a marketing incentive. The implicit financing amount is calculated using the rate that would be used in a separate financing transaction between the retailer and its customer.

Consequently, a retailer applies the rate that would be used in a separate financing transaction between it and its customer that does not involve the provision of goods or services. This can lead to practical difficulties for retailers with large volumes of customer contracts and/or multinational operations, because they have to determine an appropriate discount rate for each customer, class of customer or geographical region of customer.

Sales taxes

Retailers can elect to present sales taxes on a net basis or they can perform a jurisdictional analysis, which may result in some taxes being presented gross and others net.

Under current US GAAP, an entity makes an accounting policy election to present sales taxes and other similar taxes on a gross or net basis in the income statement.

Under the new standard, entities are permitted to elect a practical expedient to present those taxes on a net basis. The election applies to all taxes assessed by a governmental authority that are both imposed on and concurrent with the specific revenue-producing transaction and collected by an entity from a customer – e.g. sales, use, value-added and some excise taxes. Taxes assessed on the

entity's total gross receipts are not included in the scope of this election.

When the practical expedient is not elected, an entity evaluates whether the taxes are collected on behalf of a third party (e.g. government) on a case-by-case basis in each jurisdiction in which it has sales. This entails an assessment of whether each tax is imposed by the specific governmental entity on the customer or the retailer. This may result in some taxes being presented on a net basis and others on a gross basis for retailers not electing the practical expedient.

Nonrefundable up-front fee



Retailers need to evaluate the nature of up-front fees to determine the timing of revenue recognition.

Some contracts include nonrefundable up-front fees (e.g. the annual membership offered by some retailers) that are paid at or near contract inception. Under the new standard, an entity assesses whether the fee relates to the transfer of a promised good or service to the customer.

If the activity does not result in the transfer of a promised good or service to the customer, the up-front fee is an advance payment for performance obligations to be satisfied

in the future and is recognized as revenue when those future goods or services are provided, which may include future contract periods.

If the up-front fee is an advance payment for future goods or services, an entity must also evaluate whether the fee gives the customer a material right. If the fee gives rise to a material right, then it is recognized over the period for which the payment provides the customer with a material right.

Franchise arrangements

Retailers that franchise their operations may have a change in the accounting for these arrangements under the new standard.

Some retailers may franchise their operations in addition to operating their own stores. Current US GAAP provides specific guidance for the accounting for these arrangements. The new standard eliminates this specific guidance and requires the general revenue model to be applied. This requires a new

evaluation of the accounting for franchise rights, performance obligations, pre-opening activities and costs, advertising funds, end customer sales incentives, and contract modifications. KPMG's [Revenue for franchisors](#) provides discussion on the accounting for franchise arrangements.

Applicable to all industries

Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted¹. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method are required to disclose the changes between the reported results of the new standard and those that would have been reported under current US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under current US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

- certain practical expedients available during transition under the retrospective method; and
- the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

Effective dates

Type of entity	Annual reporting periods after
Public business entities and not-for-profit entities that are conduit bond obligors	December 15, 2017 including interim reporting periods within that reporting period. Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other US GAAP entities, including SEC registrants that are Emerging Growth Companies	December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019. Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

1. Staff Accounting Bulletin Topic 11.M.

Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A ‘customer’ is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.



Step 1: Identify the contract

Contracts can be written, oral or implied by an entity’s customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract’s enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).



Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.



Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from current accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

- **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.
- **Noncash consideration** received from a customer is measured at fair value at contract inception.
- **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.
- **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.



Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.



Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied **over time** if one of the following criteria are met:

- the customer simultaneously receives and consumes the benefits as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers **over time**, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a **point in time**, the following are some indicators that an entity considers to determine when control has passed. The customer has:

- a present obligation to pay;
- physical possession;
- legal title;
- risks and rewards or ownership; and
- accepted the asset.

Customer options

Customer options may be accounted for as performance obligations, resulting in more revenue deferral than under current GAAP.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a price below stand-alone selling prices.

Licensing of intellectual property

The new standard includes a framework for determining whether there is a license of IP, and the category into which it falls.

As a result, the pattern of revenue recognition for licenses could differ from legacy US GAAP.

How an entity recognizes license revenue depends on the nature of the license. There are two categories of licenses of IP.

- **Functional IP.** IP is functional if the customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality – e.g. software, biological compounds, films and television shows. Revenue is generally recognized at the point in time that control of the license transfers to the customer.
- **Symbolic IP.** IP is symbolic if it does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities – e.g. brands, trade names and franchise rights. Revenue is generally recognized over the license period using a measure of progress that reflects the licensor's progress toward completion of its performance obligation.

There is an exception to the general revenue model on variable consideration for sales- or usage-based royalties related to licenses of IP. Such a sales- or usage-based royalty is recognized as revenue at the later of:

- when the sales or usage occurs; or
- on the satisfaction or partial satisfaction of the performance obligation to which the royalty has been allocated.

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.

Assurance-type warranties will generally continue to be accounted for under existing guidance – i.e. Topic 450 (contingencies). However, a warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue, which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent.

Credit risk is no longer an indicator that an entity is a principal.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

Contract modifications

A general accounting framework provides most entities with more guidance in the new standard than under current GAAP.

The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct).

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Contract costs

More costs are expected to be capitalized under the new standard.

An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.

The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard:

- incremental costs to obtain a contract; and
- costs incurred in fulfilling a contract that are not in the scope of other guidance.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

The impact on your organization

Implementation of the new standard is not just an accounting exercise.

New revenue recognition standard and corresponding accounting changes

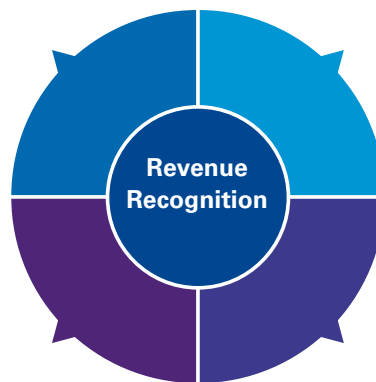
- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces

Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives



Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multinational locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates

and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's [Revenue: Issues In-Depth](#).

KPMG Financial Reporting View



Insights for financial reporting professionals

As you evaluate the implications of new financial reporting standards on your company, KPMG Financial Reporting View is ready to inform your decision-making.

Visit kpmg.com/us/frv for news and analysis of significant decisions, proposals, and final standards and regulations.

FRV focuses on major new standards (including revenue recognition, leases and financial instruments) – and also covers existing US GAAP, IFRS, SEC matters, broad transactions and more.



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Insights for financial reporting professionals

Here are some of our resources dealing with revenue recognition under the new standard.

Handbook	Assists you in gaining an in-depth understanding of the new five-step revenue model by answering the questions that we are encountering in practice, providing examples to explain key concepts and highlighting the changes from legacy US GAAP.
Issues In-Depth	Provides you with an in-depth analysis of the new standard under both US GAAP <i>and</i> IFRS, and highlights the key differences in application of the new standard. Additionally, chapter 14 provides implementation considerations.
Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
Transition options	Assists you in identifying the optimal transition method.
Industry guidance	See our other industry guidance.

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KPMG is able to assist retailers as they navigate the adoption of the new standard.

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