REVENUE RECOGNITION READINESS GUIDE

for privately held retail companies

On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued converged guidance on recognizing revenue in contracts with customers. The new guidance—FASB ASC 606 or IFRS 15, the IASB's comparable standard—replaces substantially all existing U.S. Generally Accepted Accounting Principles (GAAP) on this topic.

While the compliance deadline for public organizations has already passed, nonpublic organizations must apply the new revenue standard to annual reporting periods beginning after Dec. 15, 2018.

Not sure where to start? Use this guide to gauge your readiness and prioritize next steps ahead of the December deadline, and remember to communicate regularly with your investors, lenders, analysts, and other stakeholders to set proper expectations.

Revenue recognition guide

Use these five steps as a starting point to gauge your readiness and prioritize next steps ahead of the deadline. Remember to communicate regularly with your investors, lenders, analysts, and other stakeholders to set proper expectations.

Note that these five steps do not directly correlate with the five steps of the new revenue recognition model, but rather, represent a recommended process for overall implementation.

STEP 1: Understand, scope and plan

- ☐ Understand the new standard's requirements. Confirm your understanding with your auditor.
- ☐ Determine what, if any, new information needs to be gathered to comply with the standard.
- ☐ Assess whether your organization's existing systems, internal controls, and processes are adequate or if new systems and tools are required.
- ☐ Look beyond financial reporting to determine how the new standard may affect other aspects of your business, including marketing, sales, and pricing.
- ☐ Assess the tax implications of the new standard. If your company uses U.S. GAAP to determine revenue recognition for income tax purposes, the changes in timing of revenue recognition may result in changes to your current taxable income. It may also impact your organization's deferred taxes.
- ☐ Enlist the help of external experts, if necessary.

STEP 2: Technical analysis and assessment

- ☐ Divide your revenue into similar revenue streams and assess the impact of the standard on your revenue streams.
- ☐ Perform a detailed analysis of the accounting impact of individual transactions in the revenue streams identified. This detailed analysis should include the cost capitalization rules and should confirm and/or further your initial assessment.

Decide on one of the available transition methods and consider discussing these approaches with your financial statement users and peer organizations, if relevant.

  - ☐ **Full Retrospective:** Under this approach, entities may avail themselves of certain practical expedients.
  - ☐ **Modified Retrospective** (also referred to as the "Cumulative Effect" method): If this method is selected, entities must disclose which results would have been under prior U.S. GAAP in the year of adoption.

STEP 3: Consider changes to existing processes

- ☐ If your assessment has determined that new information will be needed, determine the changes needed to ensure that the information is gathered accurately and on a timely basis.
- ☐ Prepare for estimates and judgments. In some situations, you may be required to make more estimates and use more judgment than under current guidance, such as estimates related to variable consideration. Those matters should be highlighted for users through increased disclosure requirements.
- ☐ Depending on your analysis of the standard's potential impact on your business, consider possible changes to your organization's standard contracts.
- ☐ Consider discussing changes with lenders to revise debt covenants that are impacted by revenue, such as EBITDA and times-interest earned ratios.
- ☐ Consider possible changes to compensation arrangements that are driven by revenue, if the timing or pattern of your organization's revenue recognition changes under the new guidance.
- ☐ Revise your documented processes and controls to ensure they are sufficient to prevent or detect misstatements under the new guidance.

STEP 4: Implementation and testing

- ☐ Run applicable historical transactions through new systems and business processes to calculate the effect on prior periods or the cumulative effect upon adoption date.
- ☐ Allow time for your auditor to test your restated accounts or cumulative adjustment.
- ☐ Prepare new disclosures and ensure auditor concurrence.

STEP 5: Stay up-to-date with new guidance

- ☐ Monitor the activities of the American Institute of CPAs (AICPA) and the joint FASB/IASB Transition Resource Group.
- ☐ Stay informed on SEC developments, including any amendments the Commission may make to its own staff interpretations on revenue recognition.

SPECIAL CONSIDERATIONS FOR Privately held retailers

Sale with a right of return

Right of return provisions impact how retailers determine transaction prices, when offering the right of return to customers.

Overall, many companies will find that they may apply similar approaches as previously in order to estimate variable consideration associated with return rights, but this may be challenging for newly-launched product lines where a company may not have the historical context to estimate returns.

UNDER LEGACY U.S. GAAP	UNDER ASC 606
Historically, revenue has been recognized at the time of sale, with the caveat that future returns can be reasonably estimated based on experience. Sales are, then, recorded net of an estimated sales return reserve. If returns cannot be reasonably estimated, revenue is deferred until the return right lapses.	Return rights represent variable consideration. Estimation of variable consideration and application of the constraint are required at contract inception and must be updated at each reporting period throughout the life of the arrangement. Revenue should not be deferred simply because it is difficult to estimate returns. A liability for expected refunds to customers should be established and updated each reporting period. Additionally, an asset and corresponding adjustment to cost of goods sold is recognized for the right to recover the goods on settling the refund liability. Assets are initially measured at the cost of inventory sold less expected costs to recover the goods. Asset should be re-measured each reporting period if expectations change.

Online orders

There is diversity in practice on the recognition of revenue for online orders with respect to recognition of revenue based on the timing in which the customer receives the product.

The new revenue standard is based on the principle that revenue should be recognized when a vendor transfers control to the customer.

UNDER LEGACY U.S. GAAP	UNDER ASC 606
Companies consider at what point "risk of loss" transfers to their customers and some may recognize revenue upon shipment. However, many Companies conclude the risk of loss transfers upon delivery, and estimate an average number of days goods remain in transit to a customer and reverse any revenue recorded at the time of shipment for goods that have not reached their destination at period-end. Typically, this would be several days of revenues.	For e-retailers generating orders online, revenue recognition guidelines follow the same procedures as brick-and-mortar retailers. Revenue must be recognized at the point the e-retailer relinquishes control of the product. Accordingly, many e-retailers recognize revenue at the point of shipment as that is when the customer obtains control.

Gift cards & related breakage

Accounting for the initial sale and redemption of gift cards remains relatively consistent with prior standards. Gift cards are subject to the new guidance on variable consideration.

The primary difference is in how gift card breakage is recognized—in proportion to the pattern of customer rights exercised.

Since breakage liabilities are subject to property laws that vary state-by-state, retailers could have multiple breakage liabilities that are accounted for differently.

UNDER LEGACY U.S. GAAP

Currently, when gift cards are sold, a liability is recognized for the future obligation. Revenue is only recognized when gift cards are redeemed.

Gift card breakage—unspent balances—must be recognized in income, and under current practice there are several acceptable methods for recognizing breakage.

However, no breakage amounts should be recognized in income if the unused balances of gift cards are subject to states' escheat or unclaimed property laws.

Current GAAP allows for the following methods:

- Proportional model: Recognize as redemptions occur
- Liability model: Recognize when the right expires
- Remote model: Recognize when it becomes remote that the holder of the rights will require performance.

UNDER ASC 606

Customer purchases of gift cards create an obligation for the entity to stand ready to transfer goods or services at a future date.

Accordingly, retailers must recognize a contract liability when a customer purchases a gift card and recognize associated revenue when it fulfills the performance obligation.

Retailers that expect to be entitled to breakage should derecognize the liability (and recognize revenue) in proportion to the pattern of rights expected to be exercised by the customer, subject to the constraint on variable consideration. Such estimates may be based on historical trends for gift card redemptions, or other relevant information.

If a retailer does not expect to be entitled to a breakage amount, it should derecognize the liability when the likelihood of redemption becomes remote.

Estimated breakage amounts should be updated at the end of each period to reflect current facts and circumstances.

Customer incentives & coupons

The new standard represents a relatively minor change in the existing requirement for retailers to recognize coupons and other discounts provided to a customer as a reduction in revenue.

However, the updated requirements could potentially result in complex revenue deferrals for retailers, when incentives are considered "material rights" that must be accounted for as separate performance obligations.

UNDER LEGACY U.S. GAAP

Under current GAAP, promised deliverables for each customer incentive are identified and recognized in revenue, with multiple deliverables recognized separately only if the delivered item has stand-alone value.

UNDER ASC 606

Under the new standard, a customer incentive may be recognized as a separate performance obligation if the customer obtains a "material right" by entering into the contract. In other words, if a retailer grants a coupon to a customer at the point of sale, and the coupon grants the customer a right to a discount that is incremental to discounts offered to comparable customers, then the coupon is considered a "material right."

In this case, the retailer is required to allocate a portion of the transaction price to the coupon and recognize a corresponding liability. It subsequently recognizes revenue when the coupon is redeemed or expires. Discounts on the upfront product or incentive may need to be reallocated based on the principles of standalone selling price.

Loyalty programs

Retailers often offer loyalty or rewards programs, in which repeat customers may earn points and redeem discounted or even free goods or service based on previous qualifying purchases.

Retailers that utilize the incremental cost method to account for loyalty or rewards programs will have to modify accounting processes to apply the new guidance.

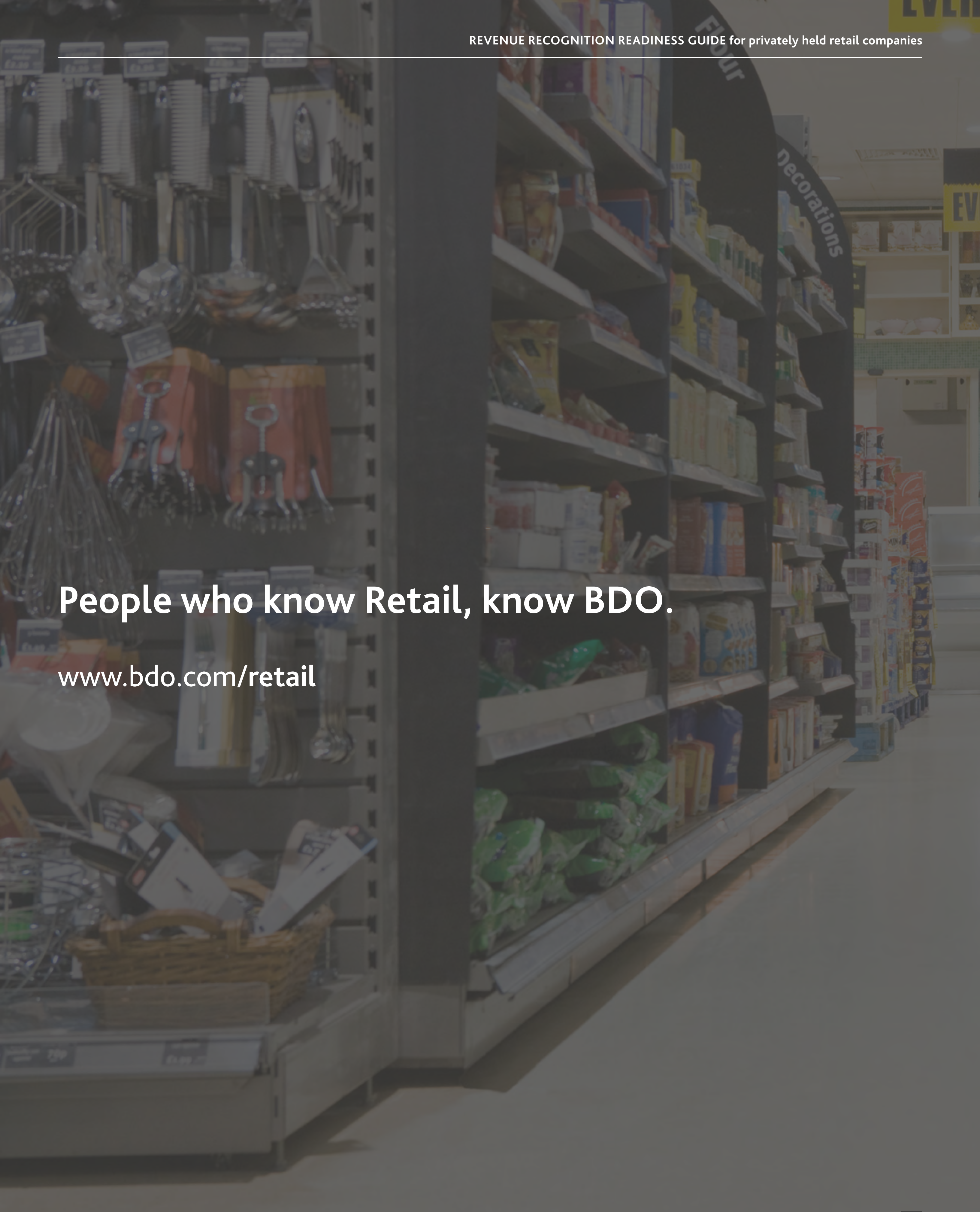
UNDER LEGACY U.S. GAAP	UNDER ASC 606
Historically, there have been two methods of recognizing revenue from loyalty programs: the **incremental cost model**, in which revenue is recognized at the time of the initial sale, and the **multiple-element model**, in which revenue is recognized as each element of the transaction is delivered.	As with coupons, points acquired through loyalty and rewards programs may be considered "material rights" to customers under the new standard and, therefore, performance obligations for retailers. If a loyalty program conveys a material right, retailers are required to defer a share of the revenue for these programs until the promised goods or services are redeemed by the customers. The new standard requires an approach similar to the multiple-element model under current GAAP.

Service agreements

Retail sales often go hand-in-hand with service agreements—especially in specialty stores like appliance, electronics or furniture retailers—where pricey service agreements are sold with the item.

UNDER LEGACY U.S. GAAP	UNDER ASC 606
Under current GAAP, revenue is recognized upon delivery of the product with an accrual for the expected costs under the warranty program.	The new guidance differentiates between the following: ▶ Assurance warranties, which are promises for products to work as intended. Assurance warranties do not result in a separate performance obligation but costs must still be accrued. ▶ Service warranties, whereby a promise is made beyond basic product performance. Service warranties result in a separate performance obligation to which revenue must be allocated. Even if the warranty is not sold separately, companies will need to evaluate if the warranty provided includes a service component. As part of a company's assessment of whether a warranty provides a customer with a service in addition to basic performance consideration should be made with respect to: ▶ Whether the warranty is required by law ▶ The length of the warranty coverage period, and ▶ The nature of the tasks that the entity promises to perform.

Additional resources are available on BDO's **Revenue Recognition Resource Center**, including an in-depth publication with examples and practical considerations.



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