REVENUE RECOGNITION STANDARD

RETAILERS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09 – Revenue from Contracts with Customers (Topic 606) which attempts to clarify the principles for recognizing revenue. Although the ASU was issued in 2014, the FASB provided a long implementation period. For entities that are not considered public business entities (PBEs), the standard becomes effective for annual reporting periods beginning after December 15, 2018, which means January 1, 2019 for calendar year-ends.

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SO WHAT CHANGED?

The recognition of revenue under current accounting standards requires the consideration of two factors; being realized or realizable and being earned. FASB believes ASU 2014-09 will significantly enhance the comparability of revenue recognition practices while also providing a framework to ensure the guidance remains relevant. Specifically, the core principle of ASU 2014-09 is "that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." To achieve the core principle, ASU 2014-09 provides a list of steps to be taken.

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

Each entity will apply this five-step approach to determine when revenue and gains included within the scope of the standard should be recognized.

STEP ONE

For step one, you have to identify if there is a contract in place with a customer. For most retail transactions, the contract is entered into because of the retailer's ordinary business practices and executed at the point of transaction (e.g. the checkout). According to the standard, a contract must be approved, create an enforceable right and obligation, have commercial substance, and collection must be probable. All these requirements are met at the point of sale. Ultimately a contract in a typical retail transaction is fairly straightforward and obvious, but be sure to evaluate all your revenue streams to determine what other types of products or services you provide customers. Those contracts could have different forms and substance which could require more analysis for compliance with the standard.

STEP TWO

For step two you have to identify the performance obligations in the contract. A contract may have distinct separate performance obligations (a good or service or a bundle of goods or services) or it may have multiple obligations that have a similar pattern of transfer to the customer and can be grouped together and treated as one performance obligation. To be considered distinct, the good or service has to provide the customer benefit on its own or with other resources that are readily available to the customer and the promise to transfer the good or service to the customer is identifiable separately from other promises in the contract. For a typical retail transaction, the purchase of the good is typically the only performance obligation. But be aware there are special circumstances that could create additional performance obligations for retailers such as warranties and loyalty programs. Warranties that go beyond assuring the good meets specifications such as repair services, extended warranties the retailer sells, or technical support could all be considered separate performance obligations. A loyalty program that offers a future good at a discount would need to be a separate performance obligation and a portion of revenue deferred until it is met. Additionally, at contract inception, you will need to determine if the performance obligation is satisfied at a point in time or over time. Typically for retail entities, revenue will be recognized at a point in time as the customer usually receives the right to the good at the point of sale.

STEP THREE

For step three, you have to determine the transaction price. In addition to fixed consideration (stated price), the transaction price also includes variable consideration. Common examples of variable consideration in the retail industry are discounts, rebates, coupons, and returns. For the most part, the variable consideration is determined at the point of transaction and accounted for in real time (e.g. a customer uses a coupon during checkout and only the amount collected is recorded as revenue). One type of variable consideration, the right to return, could cause a change in practice for retailers. If the customer has a right to return a good, the retailer

must estimate the amount of expected returns related to that good and record a Refund Liability (which would reduce revenue). This may require an evaluation of what rights of return your retail entity offers customers. Another noteworthy item to consider in determining the price is how to treat tax related items–an entity can make an accounting policy election to exclude taxes from the transaction price if they wish.

STEP FOUR

For step four, the total transaction price (from step 3) is allocated to each performance obligation (from step 2) on a standalone selling price basis (which is what you could sell that good or service for separately in similar circumstances to similar customers). If you don't know what the performance obligation would be on a stand-alone basis, you will need to estimate it. Besides doing an analysis of what it would sell for to other customers in a similar situation, you could take an expected cost plus a margin approach (costs of satisfying the performance obligation with an appropriate margin allocated to it). Another method to determine the price is using a residual approach (which is only used if you absolutely cannot determine a standalone price or if the price of that deliverable sells for a wide variety of amounts). The residual approach would be where the company takes the total contract price and backs off all of the other known costs. If you determined a contract only has one performance obligation, this step is straightforward; the entire price is allocated to the one obligation.

STEP FIVE

While steps 1-4 take place at the contract's inception, step five takes place when performance obligations are satisfied. For step five, you will actually recognize revenue for each performance obligation either over time or at a point in time. For most retail transactions, where a customer comes into a store and pays for a good, revenue will be recognized then (at a point in time). The key to identifying revenue at a point in time is identifying when control of the good transfers to the customer.

Although there are many new aspects of the revenue standard, it is likely the timing of revenue recognition for retail entities will not change unless additional performance obligations are identified such as warranties and loyalty programs. It's also possible the amount of revenue will not change, but it may due to things like refunds and returns. All relevant aspects of the standard should be evaluated to determine what specific changes your company needs to make.

If you have any questions regarding the revenue recognition standard (ASC 606) please contact us.

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