

A new global standard on revenue

What this means for the retail industry

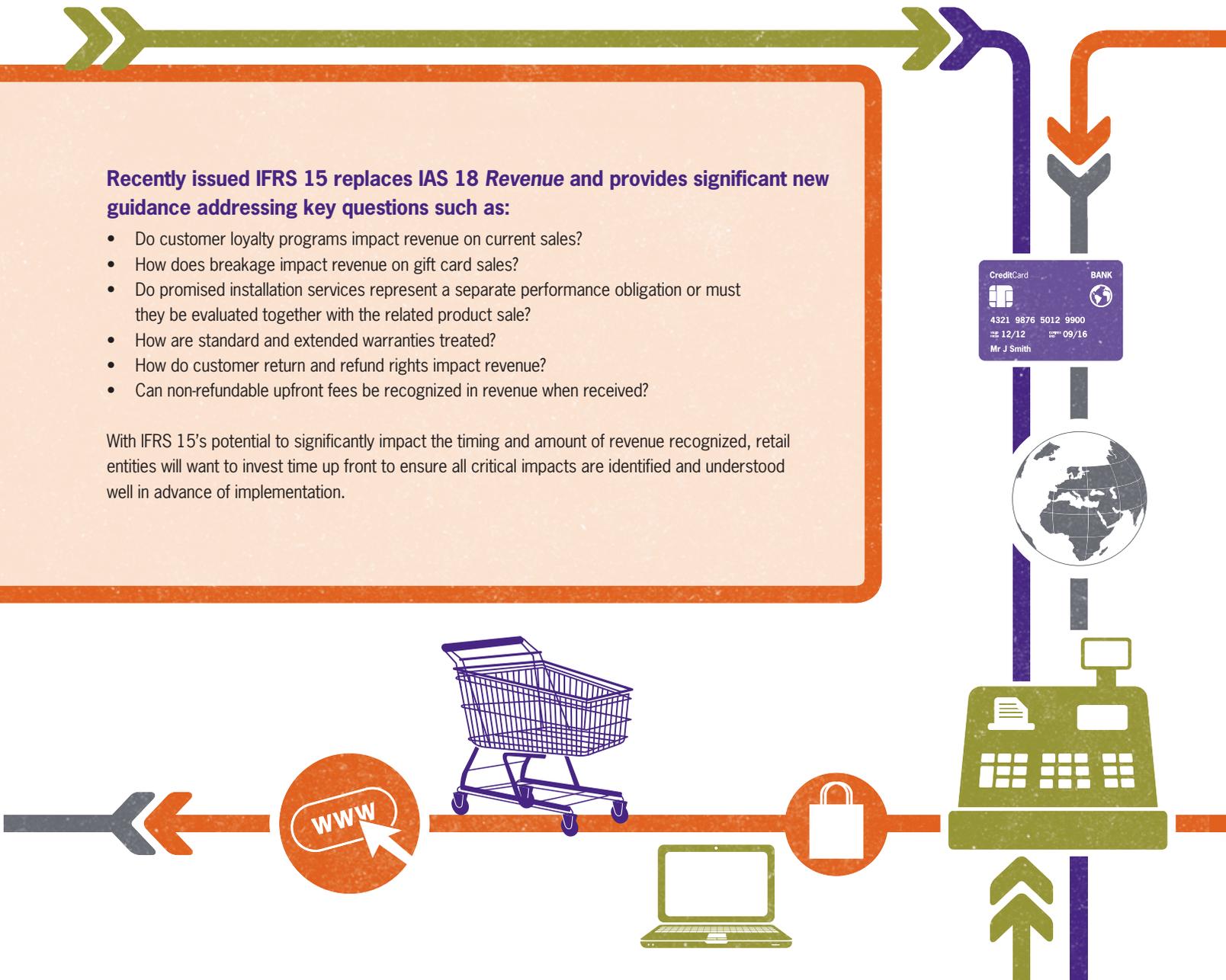
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The International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board have finally issued their new standard on revenue – IFRS 15 *Revenue from Contracts with Customers* (ASU 2014-09 or Topic 606 in the U.S.). This bulletin summarizes the new requirements and what they will mean for entities in the retail industry that apply International Financial Reporting Standards (IFRS).

Recently issued IFRS 15 replaces IAS 18 *Revenue* and provides significant new guidance addressing key questions such as:

- Do customer loyalty programs impact revenue on current sales?
- How does breakage impact revenue on gift card sales?
- Do promised installation services represent a separate performance obligation or must they be evaluated together with the related product sale?
- How are standard and extended warranties treated?
- How do customer return and refund rights impact revenue?
- Can non-refundable upfront fees be recognized in revenue when received?

With IFRS 15's potential to significantly impact the timing and amount of revenue recognized, retail entities will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.



The new standard at a glance

The new standard replaces IAS 18, IAS 11 *Construction Contracts* and some revenue-related interpretations with a control-based model centered around the following five steps:

Step 1: Identify the contract with a customer

Step 2: Identify the performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations

Step 5: Recognize revenue when or as performance obligations are satisfied

IFRS 15 changes the criteria for determining whether revenue is recognized at a point in time or over time. IFRS 15 also has more guidance in many areas where current IFRS are lacking such as:

- Multiple-element arrangements;
- Non-cash and variable consideration;
- Rights of return and other customer options;
- Seller repurchase options and agreements;
- Warranties;
- Principal versus agent (gross versus net);
- Licensing intellectual property;
- Breakage;
- Non-refundable upfront fees;
- Consignment and bill-and-hold arrangements.

IFRS 15 requires considerably more disclosure about revenue including information about contract balances, remaining performance obligations (backlog) and key judgements made.

Transition and effective date

IFRS 15 is effective for annual periods beginning on or after January 1, 2017. Transition is retrospective, subject to some simplifications, including an option to not restate comparative periods. Early application is permitted.

Accounting for revenue in the retail industry frequently exhibits traits of both routine simplicity and surprising complexity and judgement, from assessing the true nature of product warranties and complex shipping terms modified by well established (but non-contractual) practices, to evaluating the impact of complex distributor agreements where each party has specific rights over the product following delivery. With the issuance of IFRS 15, the focus shifts to the question of “control”, and this will require a change in the way entities have traditionally approached these issues.

What this means for the retail industry

Although in many cases retailers may ultimately conclude that the majority of their current accounting policies and practices will not change under IFRS 15, this can only be established after carefully assessing current practice against the new revenue model and application guidance. Also note that while the new guidance is written from the perspective of a contract with a customer, entities are allowed to apply a portfolio approach in a number of circumstances where certain conditions are met.

Step 1: Identify the contract with a customer

Step 1 of the new model is to identify the contract. Overall there are more similarities than differences between the old guidance and the new when it comes to identifying the contract.

An entity is only able to proceed to the next steps in the model if:

- the contract has commercial substance;
- the parties have approved the contract;
- each party's rights and the payment terms can be clearly identified;
- it is probable the entity will collect the consideration.

Contract approval

Under IFRS 15, approval may be evidenced in writing, orally or in accordance with other customary business practices; therefore, there is latitude in how an entity demonstrates the parties have an agreement that creates enforceable rights and obligations. While current guidance in IAS 18 is not as detailed, most retail entities are unlikely to see significant impacts in this area unless they had previously adopted an accounting policy requiring a signed contract to be in place before recognizing revenue.

Criteria not met

In circumstances where an entity has not yet concluded that the criteria above have been met, IFRS 15

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does not permit revenue to be recognized as partial cash payments are received. Instead, all revenue must be deferred until such time as the criteria are met, or until all consideration received to date is non-refundable and either performance is complete or the arrangement has been cancelled.

We do not expect this area to provide any significant challenges for the majority of entities in the retail industry.

Step 2: Identify the performance obligations

A cornerstone of the IFRS 15 model is the fact that revenue is recognized upon satisfaction of “distinct” performance obligations rather than the contract as a whole. A promised good or service is “distinct” if both:

- the customer benefits from the item on its own or along with other readily available resources;
- it is “separately identifiable” (e.g. the retailer does not provide a significant service integrating, modifying or customizing the various performance obligations).

Under IFRS 15, performance obligations are identified at contract inception and may be stated in the contract, implied by established practice, or otherwise. With the more detailed guidance the new standard provides, entities should be alert for the possibility that additional performance obligations may be identified within existing contracts and this may alter the timing of revenue recognition.

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Warranties

IAS 18 and IAS 11 do not have specific guidance on whether warranty obligations are separate deliverables. Many entities today account for extended-type warranties as separate deliverables, with allocated revenue recognized over the coverage period, while standard-type warranties are not typically regarded as separate deliverables and are instead accounted for by accruing estimated costs under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

We expect that the new guidance will not change current practice as under IFRS 15, the entity accounts for the warranty as a separate performance obligation (and therefore allocates a portion of the contract transaction price based on relative stand-alone selling price) if either condition is met:

- the customer has the option to separately purchase the warranty;
- all or part of the warranty provides the customer with an additional service beyond the assurance that the product will comply with agreed upon specifications.

If the conditions above are not met, the entity accounts for the warranty using the cost accrual guidance in IAS 37.

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Loyalty programs and other customer options for additional goods or services

IFRS 15 considers options that allow a customer to acquire additional goods or services for free or at a discount as performance obligations (whereby the retailer allocates part of the transaction price to that performance obligation) if and only if they represent a “material right”. A discount that a customer could receive without entering into a contract does not constitute a material right.

IFRS 15 replaces IFRIC 13 *Customer Loyalty Programmes* but is not expected to have a major practical effect on the accounting for many loyalty schemes. That said, IFRS 15 addresses a broader range of arrangements (such as individual discount awards that would not be viewed as “programs” under IFRIC 13) and has more detailed requirements on allocating the transaction price (see Step 4).

Gift cards: customers' unexercised rights

Gift cards represent a customer's right to receive goods or services (and the entity's performance obligation to transfer or stand ready to transfer goods or services) in the future. Therefore, IFRS 15 requires a retailer to record a contract liability in the amount of the customer prepayment for this performance obligation to transfer goods or services in the future.

Customers, however, do not always use the gift cards in full, resulting in breakage.

Under IFRS 15:

- Where an entity expects to be entitled to a breakage amount, it recognizes the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer;
- Where an entity does not expect breakage, it recognizes related revenue when the likelihood of card redemption is remote.

A retailer applies the guidance on variable consideration and constraining revenue (see Step 3) in addition to considering the local laws

regarding unclaimed property.

As IAS 18 does not provide guidance on breakage, current practice varies, with some entities recognizing related revenue only once the customer rights expire or redemption becomes remote, and others recognizing estimated breakage revenue as the underlying population of gift cards are redeemed, similar to the approach required by IFRS 15.

Step 3: Determine the transaction price

The new model (and particularly Step 3) may result in a change of thinking for retailers. Where as under existing guidance retailers determine the fair value of the consideration taking into account their estimate of any trade discounts and/or volume rebates, the approach will differ under IFRS 15.

Under IFRS 15, the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. This consideration may include fixed or variable amounts or both.

Variable pricing arrangements (e.g. rebates, awards or incentive payments) of one type or another are commonplace in the retail industry. An entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach. This amount is further subject to a revenue constraint such that estimated

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amounts are included in the transaction price only to the extent that it is highly probable that a subsequent change in the estimate will not result in a significant reversal of cumulative contract revenue recognized.

Variable consideration: performance incentives

Under the new guidance, performance incentives are treated as another form of variable consideration.

We do not expect the requirements regarding performance incentives to have a significant impact on revenue recognition timing since existing guidance requires that incentive payments be included in contract revenue when:

- it is probable that the specified performance standards will be met or exceeded; and
- the amount of the incentive payment can be measured reliably.

Variable consideration: return and refund rights

Under the new guidance, variable consideration also includes a customer's right to return goods. A retailer records a refund liability for the amount of revenue not expected to be recognized and a newly defined asset (i.e. a "contract asset") for its right to the returned goods. The asset is measured by reference to the former inventory amount, adjusted through cost of sales for recovery costs and any expected decline in value.

This is similar to existing practice where a liability and related asset are also recognized although the asset is typically presented on the balance

sheet under inventory, representing an entity's claim on the goods expected to be returned.

Under IFRS 15, the contract asset must be presented separately from inventory and will need to be assessed for impairment under IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*).

Step 4: Allocate the transaction price to the performance obligations

Currently, there is no prescriptive guidance in IAS 18 on when and/or how to allocate revenue to multiple deliverables within a contract.

Under IFRS 15, when a retailer determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on relative stand-alone selling prices.

Estimating stand-alone selling price

IFRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price. If not available, the entity

estimates the stand-alone selling price using all available information, maximizing the use of observable inputs. IFRS 15 suggests (but does not require) three possible methods: adjusted market assessment, expected cost plus margin or the residual approach.

Non-refundable upfront fees

Although the accounting conclusion may not change with respect to non-refundable upfront fees for retailers, the assessment process for such fees differs under IFRS 15.

Set up activities (e.g. retailers' "club" fees, health club joining fees, set-up fees, etc.) are not generally considered to be distinct performance obligations because the customer's ability to benefit from them is highly dependent upon other goods or

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services in the contract. In such circumstances, the related upfront fees are considered to be advance payments for future goods and services and therefore comprise part of the overall transaction price. The entity allocates the overall transaction price among the identified performance obligations and recognizes revenue as those performance obligations are satisfied (see Step 5).

Step 5: Recognize revenue when or as performance obligations are satisfied

Recognizing revenue over time or at a point in time

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

Broadly, control is transferred over time if any one of the following conditions applies:

- The customer receives and consumes the benefits as the entity performs;
- The customer controls the asset as it is created or enhanced;
- The asset has no alternative use to the seller and the seller is entitled to payment for performance-to-date.

If none of these conditions are satisfied, the entity recognizes revenue at a point in time.

While many retail contracts will transfer control at the cash register (at a point in time), an entity cannot presume that there is no change and must carefully assess when control transfers under the new model to

determine when to recognize revenue. This will be particularly true where transactions include a mixture of both products and services (e.g. extended warranty or installation services).

Sell-through arrangements

For certain arrangements with distributors, revenue cannot be recognized under the risk-and-rewards model of IAS 18 until the product is sold onwards to the end customer.

IFRS 15 provides indicators that control has transferred including (but not limited to) the following:

- The entity has a present right to receive payment for the asset;
- The customer has legal title to the asset;
- The customer has physical possession of the asset;
- The customer has assumed the significant risks and rewards of owning the asset;
- The customer has accepted the asset.

Under IFRS 15, an entity needs to carefully consider the indicators of control and both parties' rights and obligations under the agreement to determine when and how control is transferred.

In some circumstances we believe the control model of IFRS 15 will lead entities to recognize revenue sooner than the risks-and-rewards model of IAS 18.

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Licensing: franchises

IAS 18 provides limited guidance on licensing arrangements. IAS 18's guidance is consistent with IFRS 15 in that revenue is sometimes recognized over time and sometimes at a point in time, depending on the "substance of the agreement". The existence of a continuing obligation by the entity is a critical factor under existing guidance, and also under the new model in IFRS 15.

Under IFRS 15, a licence is a promise to provide "access" to the entity's intellectual property if all of the following conditions are met:

- There is a requirement or implicit understanding that the entity will undertake activities that will significantly change the underlying intellectual property;
- The customer is exposed to positive or negative effects as those activities take place;
- The activities do not transfer a good or service to the customer as they occur.

For licensing arrangements, the existence of a continuing obligation by the entity is a critical factor under existing guidance, and also under the new model in IFRS 15.

Where the licence is a promise to provide “access” to the entity’s intellectual property, control is transferred over time. If these conditions are not present, the promise is

a right to “use” the intellectual property as it exists when the licence is granted and the performance obligation is satisfied at a point in time, similar to the sale of a good.

After considering the new model, franchisors may see a change in revenue recognition timing, particularly with regard to initial franchise and area franchise fees.

Disclosures

IFRS 15 requires quantitative and qualitative disclosures that disaggregate revenue streams and identify contract assets/liabilities,

among many other new disclosures that retail entities may not have previously reported. As a result, systems and processes will need to

capture and summarize the incremental information necessary for entities in the retail industry to comply with the new requirements.



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