Food, Beverage and Beauty
ASC 606 - Common Issues/Challenges

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Today's Agenda:

1. Income Statement Classification of Consideration Paid or Payable to a Customer
2. Rights of Return
3. Customer Option for Additional Goods and Services
4. Transfer of Control
5. Bill and Hold
6. Selling-Related Goods or Services
7. Reminders

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1. Income Statement Classification Of Consideration Paid Or Payable To A Customer

- For a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct.

- If the payment to the customer is in excess of the fair value of the distinct good or service received, the entity must account for such excess as a reduction of the transaction price.

- If an entity cannot reasonably estimate the fair value of the good or service received from the customer, it is required to account for all of the consideration payable as a reduction in the transaction price.

1. Income Statement Classification Of Consideration Paid Or Payable To A Customer (Continued)

Example 1-1 – Slotting fees

Company A sells products to a retailer for $10 million. The Company A also makes a $1 million non-refundable upfront payment to the retailer for favorable product placement.

How should Company A and retailer account for the upfront payment?

Courtesy of PWC ASC 606 Guide

1. Income Statement Classification Of Consideration Paid Or Payable To A Customer (Continued)

Analysis:

The product placement services cannot be sold separately. The service is not distinct because the Company A would not obtain any rights or receive any benefit without selling products to the retailer. Company A should recognize a reduction in the transaction price of $1 million and recognize $9 million in revenue when control of the products transfers to the retailer.

From the retailer's perspective, the $1 million upfront payment for product placement services is not a payment for satisfying a distinct performance obligation and should be recognized as a reduction of cost of goods sold.

Courtesy of PWC ASC 606 Guide

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1. Income Statement Classification Of Consideration Paid Or Payable To A Customer (Continued)

- Other Common Examples:
  - *Cooperative advertising arrangements* - The determination of whether the payment from the entity is in exchange for a distinct good or service at fair value will depend on a careful analysis of the facts and circumstances of the contract.
  - *Buy downs or margin/price protection* - Normally, such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.
  - *"Pay to play" arrangements* - In most cases, these payments are not associated with any distinct good or service to be received from the customer and should be treated as a reduction of the transaction price.

Courtesy of EY ASC 606 Guide

Polling Question 1

- We will now pause for a brief polling question, which webinar attendees must answer to earn CPE credit.

- In-person attendees, if you would like CPE credit, please make sure you have signed the sign-in sheet.

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2. Rights Of Return

- Potential customer returns should be considered when an entity estimates the transaction price because potential returns are a component of variable consideration.

- Recognition of a return asset and return liability is required. Such asset and liability shall be remeasured at each reporting date.

- Return asset is initially measured at the carrying amount of the inventory, less any expected costs to recover the goods, including potential decreases in value of the goods expected to be returned.

2. Rights Of Return (Continued)

- Return asset and liability should be presented separately in the balance sheet (i.e. on a gross basis rather than a net basis).

- “Like-kind exchanges” (i.e., exchanges by customers of one product for another of the same type, quality, condition and price) are not considered returns for the purposes of applying the standard. Generally, these exchanges are nonmonetary transactions within the scope of ASC 845, *Nonmonetary Transactions*.

2. Rights Of Return (Continued)

Example 2-1 – Right of Return

Company B sells 100 beauty products for $100 each. The beauty products cost $50 and the terms of sale include a return right for 180 days. Company B estimates that 10 beauty products will be returned based on historical sales patterns. In establishing this estimate, Company B uses an expected value method and estimates a 40% probability that 8 beauty products will be returned, a 45% probability that 9 beauty products will be returned, and a 15% probability that 18 beauty products will be returned. Company B also concludes it is probable (highly probable) that there will not be a significant reversal of revenue recognized based on this estimate when the uncertainty is resolved (i.e., once the return period has expired).

How should Company B record the revenue and expected returns related to this transaction?

Courtesy of PWC ASC 606 Guide

2. Rights Of Return (Continued)

Analysis:

At the point of sale, $9,000 of revenue ($100 x 90 beauty products) and cost of sales of $4,500 ($50 x 90 beauty products) would be recognized. An asset of $500 (cost of $50 x 10 beauty products) would be recognized for the anticipated return of the beauty products (assuming they are expected to be returned in a re-saleable condition), and a liability of $1,000 ($100 x 10 beauty products) is recognized for the refund obligation. The probability of return is evaluated at each subsequent reporting date. Any changes in estimates are adjusted against the asset and liability, with adjustments to the liability recorded to revenue and adjustments to the asset recorded against cost of sales.

Courtesy of PWC ASC 606 Guide

Polling Question 2

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3. Customer Option For Additional Goods And Services

- An option to acquire additional goods or services at a discount (e.g. sales incentives, volume-tiered pricing structures, customer awards credits or contract renewal options) is a separate performance obligation in a contract with a customer only if it provides a material right to the customer that the customer would not receive without entering into the contract.

- The revenue allocated to the material right is recognized when (or as) the option is exercised (and the underlying future goods or services are transferred) or when the option expires.

3. Customer Option For Additional Goods And Services (Continued)

Example 3-1 – Free Product Rebate

Company X is running a promotion whereby an end customer who purchases three boxes of beef jerky at $20 per box in a single transaction receives an offer for one free box of beef jerky if the customer fills out a request form and mails it to Company X before a set expiration date (a mail-in rebate). Company X estimates, based on recent experience with similar promotions, that 80% of the customers will complete the mail-in rebate required to receive the free box of beef jerky.

How should the consideration be allocated to the various deliverables in the arrangement?

Courtesy of PWC ASC 606 Guide

3. Customer Option For Additional Goods And Services (Continued)

Analysis:

The purchase of three boxes of beef jerky gives the customer the right to the fourth box for free. This is a material right, which is accounted for as a separate performance obligation. The transaction price would be allocated to the right using relative standalone selling price, which considers estimated redemptions. Therefore, the value of the option would be $16 ($20 x 100% discount x 80% expected redemption). Management would allocate $12.63 ($60 x ($16 / ($16 + $60))) of the transaction price to the mail-in rebate. Company X would recognize revenue of $47.37 when control of the three boxes of beef jerky transfers, and recognize a liability for $12.63 until the rebate is redeemed or expires unredeemed. If Company X is unable to determine the number of mail-in rebates that will be used, management should assume 100% redemption. Management would allocate $15 ($60 x ($20 / ($20 + $60))) to the undelivered box and recognize revenue on delivery following redemption, expiration of the rebate, or until it is able to make an estimate. As the fourth box is a performance obligation, the cost of the fourth box should be presented as cost of sales.

Courtesy of PWC ASC 606 Guide

4. Transfer of Control

- The timing of revenue recognition could change under the new revenue standards as the transfer of risks and rewards is no longer a requirement for revenue recognition, but an indicator of when control of the goods transfers to the customer.

- Under the new standard, revenue should be recognized when control of the good or service is transferred to the customer.

4. Transfer of Control (Continued)

Example 4-1 – Shipments to Customers

Company Y enters into a contract to sell beverage products to a retailer. The delivery terms are free on board (FOB) shipping point (legal title passes to the retailer when the beverage products are handed over to the carrier). A third-party carrier is used to deliver the beverage products. Company Y has a past business practice of providing replacements to the retailer, at no additional cost, if the beverage products are damaged during transit.

The retailer does not have physical possession of the beverage products during transit, but has legal title at shipment and therefore can redirect the beverage products to another party. Company Y is also precluded from selling the beverage products to another customer while in transit.

When does control of the beverage products transfer?

Courtesy of PWC ASC 606 Guide

4. Transfer of Control (Continued)

Analysis:

Company Y would assess the indicators of transfer of control and recognize revenue when control transfers to the retailer. Though the risks and rewards of ownership have not transferred, the retailer has legal title and can direct the beverage products to another party during transit. Company Y would likely conclude that control transfers and revenue should be recognized at shipping point. Company Y should consider whether additional performance obligations exist relating to in-transit risk of loss coverage based on its past business practice.

Courtesy of PWC ASC 606 Guide

4. Transfer of Control (Continued)

Other Considerations:

- 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 to treat these costs as:

  - fulfillment activities, in which case the company accrues the costs of these activities and recognizes revenue at the point in time at which control of the goods transfers to the customer – thereby achieving matching of the expense and revenue; or
  - a performance obligation, in which case the company 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.

Polling Question 3

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5. Bill And Hold Arrangements

- The new standard may result in earlier revenue recognition if the company has met the bill-and-hold criteria and all of the other criteria related to the transfer of control.

- For a customer to have obtained control of a product in a bill-and-hold arrangement, the following criteria must be met: (i) the reason for the arrangement is substantive, (ii) the product has been identified separately as belonging to the customer, (iii) the product is ready for delivery in accordance with the terms of the arrangement, and (iv) the vendor does not have the ability to use the product or sell the product to another customer.

- Consider whether providing custodial services is a performance obligation. If so, a portion of the transaction price should be allocated to each of the separate performance obligations (that is, the goods and the custodial service).

5. Bill And Hold Arrangements (Continued)

Example 5-1 – Bill and Hold Arrangements

Company A, a wine distributor, enters into a contract to supply 100,000 cases of wine to a retailer. The contract contains specific instructions from the retailer about where the cases of wine should be delivered. Company A must deliver the cases of wine in the next year at a date to be specified by the retailer. The retailer expects to have sufficient shelf space at the time of delivery. As of year-end, Company A has inventory of 120,000 cases, including the 100,000 relating to the contract with the retailer. The 100,000 cases are stored with the other 20,000 cases, which are all interchangeable products; however, Company A will not deplete its inventory below 100,000 cases.

When should the Company A recognize revenue for the 100,000 cases of wine to be delivered to the retailer?

Courtesy of PWC ASC 606 Guide

5. Bill And Hold Arrangements (Continued)

Analysis:

Company A should not recognize revenue until the bill-and-hold criteria are met and control is transferred to the customer. Although the reason for entering into a bill-and-hold transaction is substantive (lack of shelf space), the other criteria are not met as the cases of wine for the retailer are not separated from other products.

Courtesy of PWC ASC 606 Guide

6. Selling-Related Goods Or Services

- Some “free” goods or services commonly considered marketing incentives or incidental goods or services under legacy GAAP have to be evaluated under the standard to determine whether they represent promised goods and services in a contract and identify which of those goods and services are separate performance obligations.

- For example, entities may provide product displays or employees at the retailer’s store to operate a brand-specific area or counter in the store. Under the standard, entities must identify the promised goods and services within the contract and determine which of those goods and services are separate performance obligations.

- The guidance in the standard permits an entity to disregard goods and services that are deemed to be immaterial in the context of a contract when it assesses whether promised goods or services are performance obligations.

Courtesy of EY ASC 606 Guide

Polling Question 4

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Reminders

1. Disclosure Impact

An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about:

a. Contracts with customers including revenue and impairments recognized, disaggregation of revenue, and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations);

b. Significant judgments and changes in judgments - determining the timing of satisfaction of performance obligations (over time or at a point in time), and determining the transaction price and amounts allocated to performance obligations; and

c. Assets recognized from the costs to obtain or fulfill a contract.

Reminders (Continued)

2. Helpful Resources

https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition.html

https://www.ey.com/ul/en/accountinglink/current-topics-revenue-recognition

https://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/pwc-revenue-recognition-global-guide.pdf

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Thank You!

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