Fashion and Apparel
ASC 606 - Common Issues/Challenges

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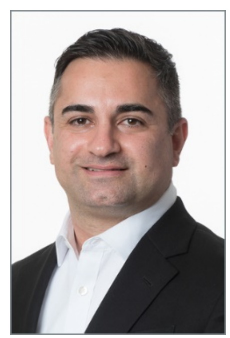

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Today's Agenda:

1. Rights of Return
2. Transfer of Control
3. Consignment Arrangements
4. Bill and Hold
5. Customer Option for Additional Goods and Services
6. Income Statement Classification of Consideration Paid or Payable to a Customer
7. Gift Card Breakage
8. License Agreements
9. Reminders

1. 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.

1. 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*.

1. Rights Of Return (Continued)

Example 1-1 – Right of Return

Company B sells 100 jackets for $100 each. The jackets cost $50 and the terms of sale include a return right for 180 days. Company B estimates that 10 jackets 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 jackets will be returned, a 45% probability that 9 jackets will be returned, and a 15% probability that 18 jackets 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

1. Rights Of Return (Continued)

Analysis:

At the point of sale, $9,000 of revenue ($100 x 90 jackets) and cost of sales of $4,500 ($50 x 90 jackets) would be recognized. An asset of $500 (cost of $50 x 10 jackets) would be recognized for the anticipated return of the jackets (assuming they are expected to be returned in a re-saleable condition), and a liability of $1,000 ($100 x 10 jackets) 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 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.

2. 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.

2. Transfer of Control (Continued)

Example 2-1 – Shipments to Customers

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

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

When does control of the sunglasses transfer?

Courtesy of PWC ASC 606 Guide

2. 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 sunglasses 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

2. 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.

3. Consignment Arrangements

- Revenue is recognized when the entity has transferred control of the goods to the distributor. The distributor has physical possession of the goods, but might not control them in a consignment arrangement.

  For example, a distributor that is required to return goods to the manufacturer upon request might not have control over those goods; however, an entity should assess whether these rights can be enforced.

- A consignment sale differs from a sale with a right of return or put right. The customer has control of the goods in a sale with right of return or a sale with a put right, and can decide whether to put the goods back to the seller.

3. Consignment Arrangements (Continued)

Example 3-1 – Sale of Products on Consignment

Company X provides children apparel products to retailer on a consignment basis. Retailer does not take title to the products until they are scanned at the register and has no obligation to pay Company X until they are sold to the consumer, unless the goods are lost or damaged while in Retailer's possession. Once the retailer sells the products to the end customer, Company X has no further obligations for the products, and the retailer has no further return rights. Any unsold products, excluding those that are lost or damaged, can be returned to Company X, and Company X has discretion to call products back or transfer products to another customer.

When should Company X recognize revenue?

Courtesy of PWC ASC 606 Guide

3. Consignment Arrangements (Continued)

Analysis:

Company X should recognize revenue when control has passed to the retailer, which requires an analysis of the indicators of the transfer of control. Although the retailer has physical possession of the products, it does not take title or have an unconditional obligation to pay Company X, and Company X maintains a right to call the products. Therefore, control does not transfer and revenue is not recognized until the product is sold to the end customer.

Courtesy of PWC ASC 606 Guide

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Polling Question 2

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

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4. 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).

4. Bill And Hold Arrangements (Continued)

Example 4-1 – Bill and Hold Arrangements

Company A enters into a contract to supply 100,000 hats to a retailer. The contract contains specific instructions from the retailer about where the hats should be delivered. Company A must deliver the hats 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 hats, including the 100,000 relating to the contract with the retailer. The 100,000 hats are stored with the other 20,000 hats, which are all interchangeable products; however, Company A will not deplete its inventory below 100,000 hats.

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

Courtesy of PWC ASC 606 Guide

4. 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 hats for the retailer are not separated from other products.

Courtesy of PWC ASC 606 Guide

5. 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.

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

Example 5-1 – Free Product Rebate

Company X is running a promotion whereby an end customer who purchases three boxes of socks at $20 per box in a single transaction receives an offer for one free box of socks 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 socks.

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

Courtesy of PWC ASC 606 Guide

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

Analysis:

The purchase of three boxes of socks 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 socks 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

Polling Question 3

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

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6. 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.

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

- 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.

Courtesy of EY ASC 606 Guide

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

Example 6-1 – Price Protection

Company Y sells a product to a customer for $100 on January 1 and agrees to reimburse the customer for the difference between the purchase price and any lower price offered by a certain direct competitor during the three-month period following the sale. Company Y has recent experience with similar promotions of similar products. On a probability-weighted basis, Company Y estimates it will reimburse the customer $5.

How should Company Y account for the potential refund?

Courtesy of PWC ASC 606 Guide

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

Analysis:

The consideration expected to be repaid to the customer should be excluded from revenue and recorded as a liability at the time of sale. Assuming management concludes, based on its recent experience, that it is probable (or highly probable) that recognizing $95 would not result in significant reversal of cumulative revenue upon resolution of the uncertainty, Company Y would recognize revenue of $95 and a refund liability of $5.

Courtesy of PWC ASC 606 Guide

7. Gift Card Breakage

- When an entity expects to be entitled to a breakage amount, it should recognize breakage as revenue in proportion to the pattern of rights exercised by the customer.

- In estimating any breakage amount, an entity has to consider the constraint on variable consideration. That is, if it is probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity should not recognize those amounts until the breakage amounts are no longer constrained.

- If an entity does not expect to be entitled to a breakage amount, it should not recognize any breakage amounts as revenue until the likelihood of the customer exercising its rights becomes remote.

7. Gift Card Breakage (Continued)

Example 7-1 – Gift Card Breakage

A customer buys a $100 gift card from Company A, which can be used for up to one year from the date of purchase. Using the guidance for variable consideration and its history of issuing gift cards, Company A estimates that the customer will redeem $90 of the gift card and that $10 will expire unused (10% breakage). Company A has no requirement to remit any unused funds to the customer or any third party when the gift card expires unused. A contract liability of $100 is recorded upon sale of the gift card.

How is revenue recognized when the gift card is redeemed?

Courtesy of PWC ASC 606 Guide

7. Gift Card Breakage (Continued)

Analysis:

For every $1 of gift card redemptions, Company A would recognize $1.11 ($1.00 x $100/$90) of revenue with $0.11 of the revenue reflecting breakage. For example, if the customer purchases a $50 product using the gift card, the retailer would recognize $55 of revenue, reflecting the product's selling price and the estimated breakage of $5.

Courtesy of PWC ASC 606 Guide

8. License Agreements

- The new standard requires that intellectual property (IP) be classified as either “functional” or “symbolic,” which impacts the timing of revenue recognition (point in time vs. over time).

- *Functional* - This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity’s IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer’s use and benefit.

8. License Agreements (Continued)

- *Symbolic:* This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor’s ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity’s IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

8. License Agreements (Continued)

Example 8-1 – Licenses

A designer of jeans has a worldwide recognized brand. A global manufacturer of dolls contracts with the designer for the right to use its brand name on the dolls' clothes. The terms of the agreement provide the doll manufacturer with rights to use the brand name on the dolls' clothes for two years. The designer will receive $1 million upfront and 12% of all proceeds from the sales of the dolls that include branded jeans. The doll manufacturer will provide updated sales estimates on a quarterly basis and actual sales data on a monthly basis.

When does the designer recognize revenue?

Courtesy of PWC ASC 606 Guide

8. License Agreements (Continued)

Analysis:

Revenue will be recognized over time. The license is a distinct performance obligation and the nature of the entity's promise is to provide a right to access the entity's IP. This would be considered symbolic IP under US GAAP.

The upfront payment of $1 million is recognized over time using an appropriate measure of progress. The variable consideration to be received by the designer depends on the level of sales of dolls and is a sales-based royalty. Therefore, the royalty component of the consideration is excluded from the transaction price until the sales have occurred, following the sales-based or usage-based royalty constraint.

Courtesy of PWC ASC 606 Guide

Polling Question 4

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

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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

Thank you!

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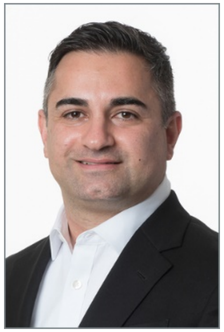

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