Revenue for consumer products companies

The new standard's effective date is coming.

US GAAP

November 2016

kpmg.com/us/frn

Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount and pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount and timing of revenue recognition.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

Read this to understand *some* of the most significant issues for consumer products companies – the issues that you should be considering now.

What's inside

Sales incentives

Coupons, discounts or rebates provided to end customers

Revenue may be reduced before an incentive offer is explicitly made based on a past practice of providing incentives to end customers.

Consumer products companies often provide coupons, discounts or rebates (incentives) to end customers to encourage the sale of their products through the distribution channel.

Under current US GAAP, consideration payable to a customer (e.g. a coupon) is recognized as a reduction to revenue at the later of when revenue is recognized and when an offer is made to a customer – which some have interpreted to be when an explicit offer is made to the customer.

Under the new standard, if consumer products companies intend to provide an incentive or if the customer can reasonably expect that an incentive will be provided, an estimate of the incentive is included in the transaction price and recorded as a reduction of revenue when the related good is sold to the distributor rather than waiting until the offer is made. This could result in earlier recognition of the incentive as a reduction in the transaction price than under current practice.

Companies will likely need to make additional judgments and develop new processes to estimate and recognize these incentives under the new standard. It may be difficult for some companies to determine the estimated incentive for a particular retailer or distributor. This may require the use of a portfolio of data, which is not the same as using the portfolio approach, to develop the estimate.

If the consumer products company does not intend to offer an incentive or if the customer does not reasonably expect an incentive because the consumer products company has not promised one to the customer, either explicitly or implicitly (including through its customary business practice), the consideration is recognized at the later of when the consumer products company recognizes revenue or when the company pays or promises to pay the consideration (the 'later of' guidance), which is similar to current US GAAP.

Example

Company C contracts with Retailer X and delivers goods on December 15, Year 1. On January 20, Year 2, Company C offers coupons in a newspaper to encourage retail sales of the goods sold to Retailer X. Company C agrees to reimburse Retailer X for coupons redeemed in its stores.

When the goods were delivered on December 15, Year 1, Company C expected to provide incentives although the specific incentives were not known. Company C offered similar coupons in prior years.

Company C would likely determine that the transaction price for the goods sold on December 15, Year 1 included variable consideration because of its business practice of providing incentives. Therefore, it would reduce its revenue on December 15 based on its estimate of coupons expected to be provided and redeemed at Retailer X's stores.

Alternatively, if Company C had not offered coupons in prior years and did not expect to offer any coupons at contract inception, then it would recognize the amount payable to the retailer as a reduction to revenue when it communicated to Retailer X its intention to reimburse Retailer X for any redeemed coupons.

Discounts and rebates provided to distributors and retailers

Most retrospective volume rebates will have similar accounting to today. However, revenue may be deferred for certain discounts on future purchases.

Consumer products companies may provide incentives directly to their customers (distributors and retailers) through volume rebates or discounts on future purchases. These incentives can take different forms. For example, some agreements provide a discount or rebate that applies to all purchases made under the agreement – i.e. the discount or rebate applies on a retrospective basis once a volume threshold is met. Or the discounted purchase price may only apply to future purchases once a minimum volume threshold has been met.

Retrospective discount

If a discount applies retrospectively to all purchases under the contract once the threshold is achieved, then the discount usually represents variable consideration under the new standard. In this case, the company:

— estimates the volumes to be purchased and the resulting discount in determining the transaction price; and

— updates that estimate throughout the term of the contract, recognizing a reduction in revenue based on the estimated transaction price when control of the underlying goods and services in the contract transfers to the customer.

A consumer products company includes variable consideration in the transaction price to the extent it is probable that a significant reversal of cumulative revenue will not occur when the uncertainty, in this instance volume, is resolved (the constraint on variable consideration).

This accounting under the new standard may be different from current US GAAP in certain circumstances because of the constraint on variable consideration guidance. For example, under current US GAAP, the maximum discount available is used as the estimated discount if the company is unable to make a reasonable estimate. The new standard does not default to the maximum discount but requires companies to evaluate the probability and significance of a reversal of revenue to determine the estimated discount.

Future discount

A consumer products company could grant its customer an option to acquire additional goods or services at a discount. That option is a performance obligation (the unit of account for revenue recognition) under the contract if it provides a material right that the customer would not receive without entering into that contract. Therefore, if a tiered pricing structure provides for discounts on future purchases only after volume thresholds are met, the consumer products company evaluates the arrangement to determine whether the arrangement conveys a material right to the customer.

A material right exists if:

— the discount provides the customer with an option to purchase additional goods or services at a price that does not reflect their stand-alone selling prices; and

— those discounts are only earned as a result of the customer entering into the arrangement.

A material right may not exist if the discounts are provided to customers in the same class regardless of whether they had qualifying prior purchases. For example, assume Customer X receives a discount based on its volume purchases in the prior year but the consumer products company provides that same discount to new customers of a similar size that were not required to make purchases in the prior year. The fact that the consumer products company does not require customers in a similar class to earn the discount indicates that the discounted pricing may not represent a material right.

If a material right exists, it is accounted for as a separate performance obligation; this results in revenue being allocated to the option and deferred until the option is exercised or expires. The amount of revenue deferred is based on the relative stand-alone selling price of the customer's option to acquire additional goods or services. If that price is not directly observable then the company will need to estimate it. This estimate reflects the discount that the customer would obtain when exercising the option, adjusted for:

— any discount the customer would receive without exercising the option; and

— the likelihood that the option will be exercised.

If a material right does not exist, there is no accounting for the future discount when recognizing revenue on the transactions completed before the volume threshold is met. Purchases after the threshold has been met are accounted for at the discounted price.

Other payments to distributors and retailers

Most slotting fees will continue to reduce revenue.

Consumer products companies often make payments to their distributors and retailers. Sometimes, the payments are for identifiable goods or services – e.g. co-branded advertising. In these cases, the goods or services provided by the customer may be distinct from the customer's purchase of the seller's products.

Under current US GAAP, cash payments made by an entity to a customer are presumed to be a reduction of revenue. This presumption can be overcome if the entity receives an identifiable benefit in exchange for the cash payment and the fair value of the benefit can be reasonably estimated. While the new standard does not contain this rebuttable presumption and only requires an entity to evaluate whether it receives distinct goods or services in exchange for the payment to the customer, most arrangements are likely to receive similar accounting treatment to that under current practice.

Like current US GAAP, if the consumer products company cannot estimate the fair value of the distinct good or service received from the customer, it recognizes the payments as a reduction of revenue. If the payments to a customer exceed the fair value of the distinct good or service provided, any excess is a reduction of revenue.

Consumer products companies typically pay slotting fees to retailers for the ability to have their product sold to the end customer by the retailer. These fees can be paid for a variety of reasons, including to obtain preferred product placement in stores, to reimburse a retailer for the removal of a competitor's inventory, and to prepare the retailer's systems to accept and sell the company's products. These payments generally do not provide the consumer products company with a service that is distinct from the sale of its product to the retailer (i.e. little to no benefit is obtained by the company without the retailer's purchase of their products). If no distinct benefit is identified, the payment is treated as a reduction of revenue, which is generally consistent with the practice under current US GAAP.

However, certain payments that may be characterized as slotting fees could provide a distinct benefit and be classified as expense. For example, if a retailer requested a donation from the consumer products company to the retailer's charity, the company may be able to conclude that the payment is distinct from its product sales, and therefore record the payment as an expense. Therefore, the appropriate accounting depends on an evaluation of each contract and the relevant facts and circumstances. See **Merchandising goods and services** for a discussion of the accounting for payments consumer products companies make to assist the retailer in their sales efforts to the end customer.

Promised goods or services to end customers

Revenue upon sale to the distributor will be deferred for promises to provide the end customer with an additional good or service.

Consumer products companies often promise goods or services as sales incentives to end customers of its customer (the distributor) to encourage the sale of its products through the distribution channel. These promises may be made explicitly in the contract with the distributor or implied by an entity's customary business practices, published policies or specific statements.

Current practice when the sales incentive is a free product or service is mixed. Many entities accrue the cost of the free product or service and recognize all of the revenue when the original good is sold to the customer.

The new standard requires an entity to evaluate the promise to the end customer to determine whether it is a performance obligation in the contract with the distributor. Promised goods or services to the end customer (i.e. the customer's customer) are accounted for as if the goods or services were promised to the customer (distributor).

Promises made explicitly or implicitly at the time the goods are sold to the distributor can be performance obligations if the promised goods or services are distinct from the other goods or services in the arrangement with the distributor. In these circumstances, revenue would then be allocated to those performance obligations and deferred until the entity has satisfied those obligations by providing the goods or services to the end customer. This means that the new standard could result in a change in practice for entities that provide incentive-type goods or services to their customers or to end customers in a distribution chain.

For example, Company X sells its product to Retailer Y with a promise to provide the end customer with an extended warranty service for no additional charge. Company X determines that the warranty service is distinct from the product and therefore allocates the revenue in the arrangement with Retailer Y between the product and the warranty service. Company X would recognize the revenue allocated to the warranty service as it provides that service to the end customer.

Promises not implied at the time the goods were sold to the distributor but made after the transfer of control of the product to the distributor (customer) are not performance obligations. All the revenue is recognized when the goods are transferred to the distributor and the entity accrues the cost of the incentive when the promise is made. A customary business practice of providing goods or services to the end customer could provide the distributor with a reasonable expectation that the goods or services will be provided in the future, thereby creating an implied promise, which would result in revenue deferral rather than a cost accrual.

Merchandising goods and services

A portion of revenue earned on the sale of products may need to be allocated to equipment or merchandising services provided to the retailer.

Consumer products companies will often provide goods and services to their customers (distributors and retailers) that are aimed at selling their products through the distribution channel to the end customer. For example, companies may provide product displays, product dispensing or storage equipment to their customers. They may also provide merchandising services within the retailer's store by operating brand-specific counters and providing various other forms of in-store advertising. Under the new standard, consumer products companies will need to determine whether these various types of goods and services are promises to their customer that represent a performance obligation.

Companies must evaluate whether control of the merchandising good is transferred to the customer. For example, if the consumer products company transfers ownerhsip of merchandising displays and equipment to the retailer, it will allocate revenue under the arrangement to the displays and equipment and recognize the allocated revenue when control is transferred. Conversely, if it retains ownership of the displays and equipment, it will record property, plant and equipment with related depreciation. In these cases, the company will need to determine whether it has provided a lease of equipment to its customer.

A company may be able to conclude that certain merchandising goods or services are immaterial in the context of a contract and therefore will not have to separately account for these goods or services as performance obligations. That determination is based on a contract-specific quantitative and qualitative assessment.

The accounting for merchandising goods will be straight-forward for those contracts where the goods are transferred to the customer at the same time as the consumer products or for those contracts where the goods are determined to be immaterial in the context of the contract. However, there could be some complexity in the accounting for contracts where the merchandising goods and consumer products are transferred at different times or where a service or a lease is being provided over time. For those situations, a portion of the product price may need to be allocated to the merchandising goods or services. Companies will likely need new processes to account for these arrangements.

Consumer products companies that provide merchandising services within the retailer's store will need to evaluate their arrangements to determine the appropriate accounting. For example, a consumer products company may provide its own employees to operate a brand-specific counter within the retailer's store and then be reimbursed by the retailer for some protion of the cost. In this case, if the consumer products company transfers control of the products when they are delivered to the retailer, the service of operating the retailer's counter may be considered a distinct performance obligation and the retailer's reimbursement of costs would be considered the transaction price that would be allocated on a relative selling price basis between the consumer products and the merchandising service.

It may also be that the retailer operates the brand-specific counter and the consumer products company reimburses the retailer for some portion of its cost. In this case, the company would account for the reimbursement to the retailer as consideration payable to a customer. The cost generally would be a reduction of transaction price that is recognized as a reduction to revenue when the company transfers the related goods to the retailer. This may require the consumer products company to estimate the payments it will ultimately make to the retailer.

Other variations of these arrangements will require consideration of all relevant facts and circumstances in the arrangement to determine the appropriate accounting under the new standard. It will also be important to determine what constitutes the legally enforceable contract with the customer as this may affect the determination of the transaction price and how it is allocated among performance obligations. The accounting for merchandising goods and services may be more complex in many instances than under current US GAAP and will require new judgments, processes and controls.

Rights of return

The balance sheet will be grossed up to present a refund liability and an asset for recovery. Some companies may experience a change in their estimates of returns.

Under current US GAAP, revenue is recognized on product sales with a right of return when certain conditions are met, including the ability to reasonably estimate future returns.

The new standard requires an entity to estimate returns and evaluate the constraint on variable consideration in determining the amount of revenue to recognize. This approach of adjusting revenue for the expected level of returns and recognition of a refund liability is broadly similar to current guidance, but some aspects of the new standard may result in changes to current practice.

— **Estimation methodology.** Under the new standard, an entity is required to estimate sales returns using either the expected value method (e.g. probability weighted estimates) or the most likely amount method. The method selected depends on which is the better predictor; the expected value method will generally be more predictive for sales returns.

  Estimated returns could result in amounts similar to current practice, but the method to estimate could be different if an entity currently uses a single best estimate approach rather than an expected value method like a probability weighted assessment or more sophisticated modeling.

  After estimating returns, an entity applies the constraint on variable consideration, which limits revenue recognition to an amount that is probable of not having a significant reversal in the future. The constraint guidance is intended to ensure that adjustments to previously constrained product or services revenue generally only are upward (i.e. increases to revenue). Because current US GAAP only requires future returns to be reasonably estimable, entities often record upward or downward adjustments to revenue as a result of the right of return guidance.

— **When reasonable estimates cannot be made.** Under current US GAAP, if a reasonable estimate cannot be made, then revenue recognition is deferred until the return period lapses or a reasonable estimate can be made.

  Revenue could conceivably be constrained to zero under the new standard. However, it is likely that most entities will have sufficient information to recognize consideration for an amount greater than zero, even when they lack historical experience on which to base the return estimate. Applying the constraint on variable consideration does not necessarily result in defaulting to zero revenue recognition (as happens under current US GAAP when a reasonable estimate cannot be made). This means that entities that are unable to reasonably estimate returns may recognize some revenue earlier under the new standard.

— **Presentation.** Under the new standard, the return is presented gross as a refund liability and an asset for recovery. This will be a change in practice for entities that currently present reserves or allowances for returns on a net basis.

— **When restocking fees are charged.** An entity sometimes charges a customer a restocking fee when a product is returned. The restocking fee is intended to compensate the entity for costs associated with a product return or the reduced selling price an entity may charge when re-selling the product to another customer. A right of return with a restocking fee is similar to a right of return for a partial refund. Therefore, restocking fees for products expected to be returned are included in the estimated refund liability when the product is sold. The refund liability is based on estimated returns less the restocking fee. Any costs related to restocking are reflected as a reduction in the carrying amount of the asset recorded for the right to recover those products. There is mixed practice in the accounting for restocking fees under current US GAAP, and therefore this may represent a change for some entities.

Example

Company C sells 20 widgets to a customer for $30 each and the cost of each widget is $15. The customer has the right to return a widget but is charged a 10% restocking fee. Company C expects to incur restocking costs of $2 per widget returned, and estimates returns to be 5%.

When control of the widgets transfers to the customer, Company C recognizes the following.

Item	What to include	Amount	Calculation
Revenue	Widgets not expected to be returned plus restocking fee on widgets expected to be returned	$573	(19[1] x $30) + (1 x $3[2])
Refund liability	Widget expected to be returned less restocking fee	$27	(1 x $30) - $3[2]
Return asset	Cost of widget expected to be returned less restocking cost	$13	(1 x $15) - $2

Notes:

1. Widgets not expected to be returned calculated as 20 widgets sold less one (20 x 5%) expected to be returned.
2. Restocking fee calculated as $30 x 10%.

Timing of revenue

Certain types of arrangements will experience a change in the timing of revenue recognition.

The new standard is a control-based model that takes a conceptually different approach to revenue recognition than current US GAAP. Under the new standard, revenue is recognized when the customer obtains control of the good or service. Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service. The timing of revenue recognition could change in some circumstances under the new standard as the focus shifts from transfer of risks and rewards to the transfer of control of the goods.

The notion of risks and rewards is only an indicator of control. Other indicators such as legal title, physical possession, right to payment and customer acceptance also need to be evaluated, based on the facts and circumstances of each arrangement.

Consumer products companies may have arrangements in which the goods are shipped to the customer FOB shipping point. Under current US GAAP, these terms may be treated as FOB destination arrangements (revenue is deferred until goods are received by the customer) when the company assumes risk of loss during transit and has determined that the risks and rewards of the goods do not pass to the customer at the shipping point. This is often referred to as 'synthetic FOB destination'. Because transfer of the risks and rewards of the asset is only one of the indicators for determining when the customer obtains control of the goods, there may be cases under the new standard in which consumer products companies determine that control of the goods in these types of arrangements transfers when the goods are shipped.

Although most consumer goods will be transferred at a point in time, it is important to remember that the new standard requires an entity to first determine whether control of the good or service transfers to the customer over time based on the criteria in the new standard.

This may be true in particular for consumer products that are produced to customer specifications where the good cannot be sold to another customer and the company has the right to payment for work in process (including a reasonable profit margin) if the customer terminates the contract for convenience. For example, a consumer products company that provides retailer-specific branded products should consider whether the over-time recognition criteria is met in their specific fact patterns. KPMG's **Revenue for Manufacturers** provides more discussion on the accounting for customized products that meet the over-time recognition criteria.

Shipping and handling services

The accounting for shipping and handling under the new standard depends on whether the activities are performed before or after the customer obtains control of the goods.

— 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.

Regardless of which policy the consumer products company uses, when it concludes that control transfers to the customer before the risks and rewards of ownership have been transferred, the company may experience a change in practice if it currently applies synthetic FOB destination accounting.

Warranties

Warranty accounting for most standard assurance warranties won't change.

But if a company provides a service in addition to assurance even if the service is not sold separately, a change in the accounting and amount of revenue recognized for the product may occur.

Under current US GAAP, product warranties are typically accounted for as a cost accrual with no effect on revenue recognition unless the entity provides the warranty through a separately priced arrangement. Revenue for separately priced warranties is measured at the contract amount and recognized over the contract period under current US GAAP.

The accounting for warranties under the new standard depends on the type of warranty being provided.

Assurance-type warranties provide a customer with assurance that the related product will function as intended and complies with any agreed-upon specifications.

Service-type warranties provide a customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

Consumer products companies should consider the nature of the tasks that are promised, the length of the warranty coverage period, whether the customer can decide to buy or not buy the warranty, and whether the warranty is required by law, to conclude on whether the company is providing an assurance or service-type warranty to the customer.

The new standard retains the current US GAAP cost accrual model for assurance-type warranties. Therefore, if the warranty cannot be purchased separately and only provides assurance that the product complies with agreed-upon specifications, the accounting for the promised warranty will not change under the new standard.

Service-type warranties are a separate performance obligation under the new revenue standard and require revenue to be allocated to them on a relative stand-alone selling price basis.

— If a customer has the option to purchase a warranty separately (e.g. because the warranty is priced or negotiated separately), the company would account for the warranty as a separate performance obligation because the company promises to provide a service to the customer in addition to the product.

— If the customer does not have the option to purchase the warranty separately, but the company provides a service to the customer in addition to warranting that the product complies with the agreed-upon specifications, this additional service is also a separate performance obligation.

The new standard may result in changes for some companies because:

— the allocated revenue amount may differ from the separately-stated contract amount that is used under current US GAAP; or

— the allocation and deferral of revenue is required for a service-type warranty when the warranty is not separately priced.

In addition, if a consumer products company provides a warranty that includes both an assurance element and a service element and the company cannot reasonably account for them separately, it accounts for both of the warranties together as a single performance obligation which may defer revenue differently from current practice.

Companies that experience losses or thin margins when providing service-type warranties will need to be mindful of how the new standard interacts with current loss accrual guidance. Current loss accrual guidance applies only to separately priced warranties. Under the new standard when an entity has a separate performance obligation for a service-type warranty that is not separately priced, the loss accrual guidance does not apply. Therefore, consumer products companies may have different accounting for embedded losses on a service-type warranty depending on whether it is priced separately. Also, the loss recorded under current US GAAP today may change even for those warranties that are separately priced; this is because the loss is based on the allocated relative stand-alone selling price under the arrangement, which may not be the same as the separately stated price for the warranty.

Sales to distributors on a sell-through basis

Companies applying the sell-through method of accounting will likely experience an acceleration of revenue and cost recognition.

Many consumer products are sold to end customers through distributors or resellers, and some companies recognize revenue on a sell-through basis – i.e. when the good or service is sold by the distributor to the end customer. This is because, for example, the concession risk renders the price to the distributor to not be fixed or determinable. Sell-through accounting is no longer appropriate under the new standard when control of the goods transfers at the time the products are delivered to the distributor.

Under current US GAAP, some entities conclude that the price charged to the distributor is not fixed or determinable, or that the significant risks and rewards of ownership have not been transferred to the customer if the entity has a history of offering price concessions such as price protection or accepting product returns if the distributor is unable to sell the products to end customers. These entities recognize revenue when they have evidence that the distributor has sold the product to an end customer (i.e. sell-through accounting), rather than when they sell products to the distributor (i.e. sell-in accounting). Other entities conclude that the price charged to the distributor is fixed or determinable because they can reasonably predict the amount of concessions or returns that will be given to the distributor based on the entity's historical experience. These entities recognize revenue on a sell-in basis.

Under the new standard, consumer products companies will be required to estimate the amount of consideration to which they expect to be entitled when they transfer control of the products to their customers (the distributors or resellers). The amount of revenue that is recognized would include an estimate of price concessions and would be constrained to the amount that does not result in a risk of significant reversal of revenue. It would be unlikely that the transaction price would be constrained to zero in most circumstances. This estimate is updated each reporting period until the uncertainty is resolved.

Companies that apply sell-through accounting under current US GAAP for non-consignment sales will generally conclude that control transfers to the distributor on a sell-in basis. This is because the transfer of risks and rewards is only one of several indicators of control and the distributor can generally direct the use of and obtain the benefits from the products when they are received.

The timing of control transfer is important because the company derecognizes its inventory and records costs of sales at that point – even if the revenue is significantly constrained because of the probability of a significant revenue reversal. As a result, in certain circumstances a company may be required to recognize costs before recognizing much of the expected revenue; this is because the revenue is significantly constrained by the risks that cause the amount not to be fixed or determinable under current US GAAP.

Consignment activities

Revenue from consignment arrangements is not recognized when products are delivered to the intermediary.

A consumer products company may enter into consignment arrangements to deliver goods to a retailer or distributor but retain control of the goods. The new standard provides indicators that an arrangement is a consignment arrangement:

— The entity controls the product until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.

— The entity is able to require the return of the product or transfer the product to a third party, such as another dealer.

— The dealer does not have an unconditional obligation to pay for the products, although it might be required to pay a deposit.

These types of arrangements do not allow the entity to recognize revenue on delivery of the products to the intermediary because it has not transferred control of the products to the intermediary. The assessment of control is different from the risk-and-rewards approach under current GAAP. However, consideration of whether the significant risks and rewards of ownership have been transferred is an indicator of the transfer of control and conclusions about when control has passed to the intermediate party or the end customer are generally expected to stay the same.

Costs to obtain a contract

Companies will no longer have the choice to expense commissions as incurred if certain criteria are met.

Under current SEC guidance, an entity can elect to capitalize direct and incremental contract acquisition costs (e.g. sales commissions) in certain circumstances, although many entities expense the costs as incurred.

Under the new standard, an entity is required to capitalize costs to obtain a contract if those costs are only incurred as a result of obtaining a contract and the entity expects to recover them – unless it elects the practical expedient for costs with amortization periods of one year or less. The amortization period is based on the term of the customer contract to which the cost relates and any anticipated renewals. For example, an entity that pays commissions upon the sale of a product that also includes a renewable warranty will need to consider how the renewable warranty affects the determination of the appropriate amortization period.

The requirement to capitalize the costs of obtaining a contract will be a change for consumer products companies that currently expense those costs. It may also be complex to apply, especially for companies with many contracts and a variety of contract terms and commission and incentive structures. Companies must evaluate when to capitalize commissions paid on renewals and the appropriate amortization periods for initial commissions and renewal commissions.

Those companies that have not previously tracked the costs of acquiring a contract, and have expensed them as they were incurred, may find it difficult to determine which costs to capitalize, both for the transition amounts on adoption (regardless of the transition method used) and in the ongoing application of the new standard.

A company that currently capitalizes the costs to obtain a contract will need to assess whether its current capitalization policy is consistent with the new requirements. For example, a company that currently capitalizes incremental bid costs will need to identify those costs that are incurred because it obtained the contract, and exclude bid costs that are incurred irrespective of whether the contract is obtained. Likewise, a company that capitalizes both incremental and allocable costs (e.g. employee costs) of obtaining a contract will need to revise its policy to capitalize only the incremental costs of obtaining a contract.

The new standard also amends existing cost capitalization guidance to require the costs of direct-response advertising to be expensed as they are incurred, because they are not incremental costs to obtain a specific contract.

Principal vs. agent

Most principal versus agent conclusions are unlikely to change, but these conclusions should be analyzed under the new framework.

When other parties are involved in providing goods or services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services themselves, or to arrange for them to be provided by another party – i.e. whether it is a principal or an agent.

This determination is made by identifying each good or service promised to the customer in the contract and evaluating whether the entity obtains control of the specified good or service before it is transferred to the customer. 'Control' is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services (or prevent others from doing so).

The new standard provides indicators to assist with the evaluation of whether the entity controls the good or service before it is transferred to the customer and is therefore a principal in the transaction. However, some of the indicators used in current US GAAP for assessing whether a party is a principal or an agent are not included in the new standard – e.g. discretion in supplier selection, involvement in determining the product or service specifications, and customer credit risk. Also, the new standard does not identify any of the indicators as being more important than others, whereas current US GAAP specifies that the primary obligor and general inventory risk are stronger indicators of a principal.

Because an entity evaluates whether it is a principal or an agent for each good or service to be transferred to the customer, it is possible for the entity to be a principal for one or more goods or services and an agent for others in the same contract. This could affect the allocation of revenue to the distinct goods or services within the contract.

Based on the changes to the principal versus agent guidance introduced by the new standard, consumer products companies will need to reconsider their conclusions, which could result in changes to current accounting, particularly if credit risk is a key factor in a principal conclusion under current US GAAP.

Sales taxes

Companies can elect to present sales taxes on a net basis or they can perform a jurisdictional analysis, which may result in some taxes being presented gross and others being presented net.

Under current US GAAP, an entity makes an accounting policy election to present sales taxes and other similar taxes on a gross or net basis.

Under the new standard, entities are permitted to elect a practical expedient to present those taxes on a net basis. The election applies to all taxes assessed by a governmental authority that are both imposed on and concurrent with the specific revenue-producing transaction and collected by an entity from a customer – e.g. sales, use, value-added and some excise taxes. Taxes assessed on the entity's total gross receipts or imposed during the inventory procurement process are not included in the scope of this election.

When the practical expedient is not elected, an entity evaluates whether the taxes are collected on behalf of a third party (e.g. government) on a case-by-case basis in each jurisdiction in which it has sales (i.e. a principal versus agent evaluation). This may result in some taxes being presented on a net basis and others on a gross basis for entities not electing the practical expedient.

Applicable to all industries

Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

— disaggregation of revenue;

— contract balances, including changes during the period;

— performance obligations;

— significant judgments; and

— assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted[1]. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method, are required to disclose the changes between the reported results of the new standard and those that would have been reported under current US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under current US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

— certain practical expedients available during transition under the retrospective method; and

— the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

Effective dates

Type of entity	Annual reporting periods after
Public business entities and not-for- profit entities that are conduit bond obligators	**December 15, 2017 including interim reporting periods within that reporting period.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other US GAAP entities, including SEC registrants that are Emerging Growth Companies	**December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

1 Staff Accounting Bulletin Topic 11.M.

Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A 'customer' is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.

Step 1: Identify the contract

Contracts can be written, oral or implied by an entity's customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract's enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).

Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.

Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from current accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

— **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

— **Noncash consideration** received from a customer is measured at fair value at contract inception.

— **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.

— **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.

Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied ***over time*** if one of the following criteria are met:

- the customer simultaneously receives and consumes the benefits as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers ***over time***, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a ***point in time***, the following are some indicators that an entity considers to determine when control has passed. The customer has:

- a present obligation to pay;
- physical possession;
- legal title;
- risks and rewards or ownership; and
- accepted the asset.

Customer options

Customer options may be accounted for as performance obligations, resulting in more revenue deferral than under current GAAP.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a price below stand-alone selling prices.

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.

Assurance-type warranties will generally continue to be accounted for under existing guidance – i.e. Topic 450 (contingencies). However, a warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent.

Credit risk is no longer an indicator that an entity is a principal.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

Contract modifications

A general accounting framework replaces specific contract modification guidance for long-term construction- and production-type contracts. However, outside of these arrangements, an entity will find more guidance in the new standard than under current GAAP.

The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct).

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Contract costs

More costs are expected to be capitalized under the new standard.

An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.

The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard:

— incremental costs to obtain a contract; and

— costs incurred in fulfilling a contract that are not in the scope of other guidance.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs:

— relate directly to an existing contract or specific anticipated contract;

— generate or enhance resources that will be used to satisfy performance obligations in the future; and

— are expected to be recovered.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

The impact on your organization

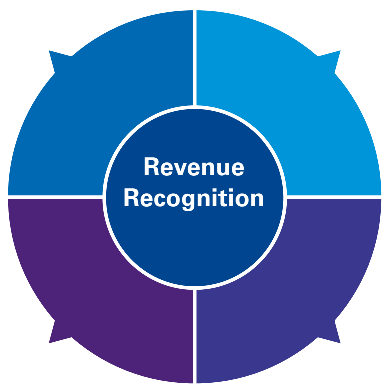
Implementation of the new standard is not just an accounting exercise.

New revenue recognition standard and corresponding accounting changes

- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces



Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives

Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multi-national locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's **Revenue: Issues In-Depth**.

Keeping you informed

KPMG's Financial Reporting Network (FRN) provides a single source for the latest, executive-level financial reporting information, as well as news and activity from standard setters and industry sources – all organized by topic. It has been designed to help executives and accounting professionals stay in front of critical issues in today's evolving financial reporting environment. We not only keep a close watch on the latest financial reporting developments, we report on them and interpret what they might mean for you.

You can find the following and other insightful publications, webcasts, and in-person executive education on FRN.

Visit us at kpmg.com/us/frn	
Revenue: Issues In-Depth	Provides you with an in-depth analysis of the new standard, including our additional insights and extensive examples. Additionally, chapter 14 provides implementation considerations. Our Issues In-Depth is supplemented by Defining Issues as new developments occur.
Revenue: Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
Revenue: Transition options	This publication will assist you in identifying the optimal transition method.

Contacts

KPMG is able to assist consumer products companies as they navigate the adoption of the new standard.

Allan Colaco
Partner – U.S. Food, Drink, and Consumers Goods Audit Leader

345 Park Avenue
New York, NY 10154
Tel: 212-909-5629
acolaco@kpmg.com

Prabhakar Kalavacherla ("PK")
Partner – Global Revenue Topic Team Leader

55 Second Street, Suite 1400
San Francisco, CA 94105
Tel: 415-963-8657
pkalavacherla@kpmg.com

Brian K Allen
Partner – U.S. Revenue Topic Team Leader

345 Park Avenue
New York, NY 10154
Tel: 212-954-3621
ballen@kpmg.com

Meredith L Canady
Partner – Department of Professional Practice

345 Park Avenue
New York, NY 10154
Tel: 212-909-5858
mcanady@kpmg.com

kpmg.com/socialmedia