

Selected Issues in ASC 606 Implementation

Even after mastering the five-step model, applying ASC 606 consistently can get complicated. This course examines selected issues that commonly arise when working through the revenue recognition steps, helping professionals identify problem areas and avoid missteps. If you're dealing with complex contracts, variable consideration, or performance obligation questions in your practice or organization, this course addresses the nuanced situations where judgment and technical knowledge matter most.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize how to account for the transfer of a product with a right to return.
- Recognize the requirement that must be met for a company to be considered a principal in a revenue transaction.
- Recall the general rule that determines whether an entity should record revenue gross or net.
- Identify several types of warranties accounted for under the revenue standard.
- Identify different types of intellectual property subject to the licensing rules in the revenue standard.
- Recognize an example of a prepaid stored-value product.
- Recall how an entity should account for breakage related to prepaid stored-value products.

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Section 5

Chapter Objective

After completing this assignment, you should be able to:

- Recognize how to account for the transfer of a product with a right to return.
- Recognize the requirement that must be met for a company to be considered a principal in a revenue transaction.
- Recall the general rule that determines whether an entity should record revenue gross or net.
- Identify several types of warranties accounted for under the revenue standard.
- Identify different types of intellectual property subject to the licensing rules in the revenue standard.
- Recognize an example of a prepaid stored-value product.
- Recall how an entity should account for breakage related to prepaid stored-value products.

VII. SELECTED ISSUES IN APPLYING THE FIVE STEPS OF THE REVENUE MODEL

The author addresses some of the key issues related to the new revenue standard as follows:

E. Warranties

F. Bill-and-Hold Arrangements

G. Consignment Arrangements

H. Licensing

I. Presenting *Sales Taxes* and Other Similar Taxes Collected from Customers

J. Shipping and Handling- Step 2 Identifying Performance Obligations

K. Breakage in Prepaid Gift Cards

A. SALE WITH A RIGHT OF RETURN

It is common for retailers, manufacturers and other companies to provide customers with the right to return a product for a full or partial refund, a credit, or an exchange for another product.

In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receives any combination of the following:

- A full or partial refund of any consideration paid,

- A credit that can be applied against amounts owed, or that will be owed, to the entity, or
- Another product in exchange.

ASC 606 offers a few comments about such returns:

1. A company's right of return policy might be explicitly stated within the customer contract, or it might be implicitly applied on a case-by-case basis.
2. Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one color or size for another) are not considered returns.
3. ASC 606 provides the following rules to account for the right to return a product:
 - a) To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following at the time revenue is recognized in Step 5:
 - 1) Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
 - 2) A refund liability (portion of the revenue not expected to be entitled to)
 - 3) An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

Note

An asset (and corresponding adjustment to cost of sales) represents the entity's right to recover products from customers on settling the refund liability. The asset should initially be measured by reference to the former carrying amount of the inventory less any expected costs to recover those products. Subsequently, an entity should update the measurement of the asset to correspond with changes in the measurement of the refund liability.

- b) An entity's promise to stand ready to accept a returned product during the return period would not be accounted for as a separate performance obligation in addition to the obligation to provide a refund.

Note

The cumulative amount of revenue the entity recognizes *to date* shall not exceed the amount to which the entity is reasonably assured to be entitled.

- c) For any amounts to which an entity *does not expect to be entitled*, the entity should not recognize revenue when it transfers products to customers but should recognize any consideration received as a *refund liability*.

Note

Because the contract allows a customer to return the goods, the consideration received from the customer is considered variable consideration. Variable consideration should be measured using either the *expected value method* or the *most likely amount method*. The expected value method is based on the sum of probability-weighted amounts in a range. Other companies might use the most likely amount method in which a *single most likely amount* in a range is selected. For example, a retailer estimates the percentage of returns is between 2% and 3%. The entity could choose 3% for its returns calculation.

- 1) Subsequently, the entity should update its assessment of amounts to which the entity is reasonably assured to be entitled in exchange for the transferred products and should recognize corresponding adjustments to the amount of revenue recognized.
- 2) An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

Example: Right of Return [from ASU 2014-09, as modified by the Author]

Facts:

An entity sells 100 products for \$100 each.

The cost of each product is \$60.

The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund.

The entity estimates (using the *most likely amount method*) that *three products (3%) will be returned*. The entity's experience is predictive of the amount of consideration to which the entity will be entitled.

The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

Conclusion:

Upon transfer of control of the products, the entity should not recognize revenue for the three products that it expects to be returned. Consequently, the entity should recognize:

Total sales	100 units x \$100 =	\$10,000
Estimated returns	3 units x \$100 =	(300)
Sales not expected to be returned	97 units x \$100 =	<u>\$9,700</u>
Entry at date of transfer of control (sale date):		
	dr	cr
Accounts receivable	10,000	
Revenue		9,700
Refund liability		300
Cost of sales (97 x \$60)	5,820	
Recovery asset (3 x \$60)	180	
Inventory (100 x \$60)		6,000

Observation

Historically, most companies have recognized returns and allowances on a cash basis when the return was actually made.

ASC 606 requires the return and allowance to be recognized at the time the revenue is recorded as a direct reduction of the revenue recognized. Most significant is that there are now a recovery asset and return liability that must be recognized at the time revenue is recorded to reflect the estimates of the returns. The asset is recorded at its inventory carrying amount on the books at the time of sale (e.g., amount at which it is recorded) less any costs, if any, to recover the asset. Once the asset is recorded, it must be evaluated for impairment under ASC 606, and not treated for impairment or lower of cost or market (or lower of cost and net realizable value) under the inventory rules found in ASC 330, Inventory.

B. SALE WITH A REFUND LIABILITY

Similar to a sale with a right to return the goods, it is common that an entity sells goods and offers a form of refund or discount if a customer achieves a defined milestone, such as selling a certain volume of goods on a cumulative basis.

ASC 606 treats such a transaction similar to the way in which a sale with a right of return is accounted for. That is, at the time of recognizing revenue (Step 5), an entity might be required to record the discount as a *refund liability*.

Following are the rules found in ASC 606-10-32-10:

1. An entity shall recognize a *refund liability* if the entity receives consideration from a customer and *expects to refund some or all of that consideration to the customer*.

2. A refund liability is measured at the amount of consideration received (or receivable) for which the entity *does not expect to be entitled* (that is, amounts not included in the transaction price).
3. The refund liability (and corresponding change in the transaction price and, therefore, the contract liability) shall be updated at the end of each reporting period for changes in circumstances.

Note

If the transaction relates to a sale with a right of return of the goods, the transaction should be accounted for under the sale with a right-of-return rules previously discussed in this chapter, which also require that a refund liability (and related asset) be recorded at the time revenue is recognized in Step 5 to reflect the amount of anticipated return of goods.

Example 1: Sale with Refund Liability

Sarah's Hot Muffins (Sarah) sells muffins to a distributor and enters into a contract to sell muffins. Under the contract, Sarah sells her muffins to the distributor at \$1.00 per muffin on the first 2 million units. Once the customer achieves 2 million units, the customer receives a retroactive price to the first unit of \$.80 per unit.

Goods are sold and shipped to the customer in increments of 100,000 units, at which time the customer receives control.

On the date of transfer (shipping) of goods to the customer, the company has an unconditional right to consideration** for the goods.

The Company determines that revenue in Step 5 should be recognized at a point in time as each goods are transferred to the customer.

Moreover, the company, based on historical sales, expects that the customer will easily achieve the 2 million unit sales so that the sales price on all units retroactively is \$.80.

On March 15, 20X9, the Company ships to the customer 100,000 units and should make the following entry at the date control is transferred to the customer, which is March 15, 20X9.

Conclusion:

On March 15, 20X9, control of 100,000 units is transferred (shipped) to the customer at which time X should record revenue using the point in time approach in Step 5. However, because the company expects to refund \$.20 of the \$1.00, it should record a refund liability for the \$.20, which is the amount for which the entity does not expect to be entitled.