Project **Revenue Recognition**

Topic **Sale of goods with the right of return**

Purpose of the paper

1. This paper considers how an entity should account for the sale of goods with a right of return in the proposed revenue recognition model.

2. A right of return means that the customer has an *unconditional* right to return the purchased product and, in effect, reverse the sales transaction. This differs from product warranties that permit a customer to return a product only if it is defective.

Summary of recommendations

3. When accounting for the sale of goods with a right of return, this paper recommends that:

   (a) An entity should not recognize revenue for the goods that are expected to be returned, but instead should recognize a refund liability for the expected (probability-weighted) amount of refunds to customers.

   (b) Subsequently, an entity should update the refund liability for changes in expectations about the amount of refunds and make a corresponding adjustment to the amount allocated to the performance obligations.

   (c) An entity should recognize an asset (and corresponding adjustment to cost of sales) for its right to recover goods from customers on settling the refund liability, initially measured at the original cost of the goods (that is, the former carrying amount in inventory).

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

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(d) The promised return service meets a definition of a performance obligation. However, an entity should allocate a portion of the transaction price to that performance obligation only if it is material.

Structure of the paper

4. This paper is organized as follows:

   (a) Proposals in the Discussion Paper (paragraphs 5–8)

   (b) Respondents' feedback on the Discussion Paper (paragraphs 9–12)

   (c) Analysis of respondents' feedback (paragraphs 13–36)

      (i) Refund obligation

      (ii) Performance obligation for return service

      (iii) Changes in expectations

      (iv) Returned inventory

Proposals in the Discussion Paper

5. The Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, discussed two views on how to account for the sale of goods with a right of return: the performance obligation approach and the failed sale approach.

6. Under the performance obligation approach:

   (a) The promise to provide a return right is a performance obligation in the contract.

   (b) Revenue is recognized for all goods transferred to customers.

   (c) However, some of the transaction price in each contract is allocated to the return service and recognized as revenue when the return services are provided.

7. Under the failed sale approach:

(a) The promise to provide a return right is not a performance obligation in the contract.

(b) If the entity is able to estimate reliably the proportion of goods likely to be returned, revenue (and cost of sales) is recognized only for goods transferred to customers that are expected to result in successful sales (that is, for sales that will not fail).

(c) The entity continues to recognize inventory for the goods expected to be returned.

8. Members of the Boards had mixed views on which approach is more appropriate, and did not reach a preliminary view prior to publishing the Discussion Paper.

Respondents' feedback on the Discussion Paper

9. Respondents to the Discussion Paper also had mixed views regarding the two approaches. However, they also identified problems with each approach as outlined in the Discussion Paper.

10. Respondents who disagreed with the performance obligation approach most often stated that:

(a) The obligation to provide a return service is a contingent obligation and should not be viewed as a performance obligation to provide a good or service.

(b) A performance obligation for a return right will result in the recognition of revenue as goods are returned, which does not seem appropriate because the entity does not retain consideration from customers who return their goods.

(c) The performance obligation approach seems to result in recognition of revenue in excess of the amount of consideration ultimately retained by the entity.

11. Respondents who disagreed with the failed sale approach most often expressed discomfort with the resulting effect on the entity's statement of financial position. Control of the good seems to have transferred to the customer, but the good continues to be recognized in the entity's inventory.

12. Many respondents commented that the existing accounting for right of returns provides decision-useful information and is straightforward to apply. They encouraged the Boards to retain that accounting.

Analysis of respondents' feedback

13. In light of the feedback received from respondents, as well as recent Board deliberations regarding uncertain consideration, the staff proposes a revised analysis of the right of return. This analysis can be viewed as a hybrid of the two approaches considered in the Discussion Paper.

Refund obligation

14. When an entity sells goods with a return right, the entity can be viewed as having made an uncertain number of sales. Only after the return right expires does the entity know with certainty how many sales it made (in other words, how many sales did not fail).

15. Therefore, for the sales that the entity made but which are expected to fail, the entity should not recognize revenue. Instead, the entity should recognize a liability for its obligation to refund the consideration to customers. This liability should reflect the entity's expected (probability-weighted) amount of refunds to customers.

16. This accounting can also be viewed as analogous to the accounting for uncertain consideration. When the entity sells a good with a return right, the transaction price can be viewed as being uncertain at the point of sale, because the entity does not know whether it will retain the consideration. Consistent with the Boards' decision for uncertain consideration, the transaction price for each contract entered into can be viewed as being the expected (probability-weighted)

amount of consideration to be retained by the entity. The difference between this amount and the cash collected from the customer is therefore the amount of the refund obligation.

17. This is illustrated in the following example:

EXAMPLE 1: Refund obligation

HenryCo sells 100 goods with return rights for CU100. Each good costs CU20 to produce. HenryCo estimates that there is a 2% probability that each good will be returned by the customer. For simplicity, it is assumed that the goods cannot be resold by the entity other than for scrap for an immaterial price.

HenryCo estimates that 2 sales will fail (100 x 2%). A refund liability is therefore recognized for CU200 (2 x CU100).[1] The amount of the consideration attributed to the performance obligations in the contracts is CU9800 (i.e., (100 x CU100) – CU200),

(The transaction price on each contract can also be viewed as the probability weighted amount of customer consideration, CU98 ((CU100 x 98%) + (CU0 x 2%)). So the refund obligation per contract is CU2 (CU100 – CU98).)

To initially record the contract:

dr Cash	10000	
cr Contract liability		
for the performance obligations		9800
cr Refund obligation		200

To record the refunds:

dr Refund obligation	200	
cr Cash		200

The revenue recognized on satisfying the performance obligations will be equal to the cash retained by the entity, CU9800. (The next section of the paper considers the performance obligations.)

[1] The estimate of returns has been simplified in the example for illustrative purposes. In practice, this estimate would use a probability weighted calculation to reflect the likelihood of different scenarios.

Deposit floor

18. In the above accounting the refund obligation is not subject to the 'deposit floor' as IAS 39 *Financial Instruments: Recognition and Measurement* and U.S. GAAP would require if the obligation were a financial liability with a demand feature. In other words, the refund obligation is measured at *less* than the amount payable on demand by customers. The staff acknowledges this inconsistency, but if the deposit floor were to be applied, then the entity would recognize no revenue until the return period expires.

Performance obligation for return service

19. The staff thinks that in the above example there are, in concept, two performance obligations in each contract:

    (a) A performance obligation to provide the good

    (b) A performance obligation for the return right service.

20. The return right performance obligation reflects the activities involved in processing the returns and the bearing of risk by the entity. However, it does not reflect the cash that will be refunded to customers.

21. Therefore, in concept, the transaction price should be allocated to the two performance obligations. Revenue for the good should be recognized when the customer obtains control of the good, and revenue for the return right service should be recognized as the customer receives those services over the life of the right:

EXAMPLE 2: Performance obligation for return service

Assume the same facts as in Example 1.

HenryCo estimates the standalone selling price of the good to be CU99.5 and the standalone selling price of the return rights to be CU0.5. (For simplicity, it is assumed there is no discount in the contract.)

Therefore, the amount allocated to the goods is CU9751 (CU99.5 x 98 contracts) and the amount allocated to the return service CU49 (CU0.5 x 98).

To record the sale of goods:

dr Cash	10000	
cr Revenue		9751
cr Return Service performance obligation		49
cr Refund Obligation		200
dr Cost of goods sold	2000	
cr Inventory		2000

To record revenue for refund service over refund period:

dr Return Service performance obligation	49	
cr Revenue		49

To record the refunds:

dr Refund obligation	200	
cr Cash		200

The revenue recognized on satisfying the performance obligations is equal to the cash retained by the entity, CU9800

22. In support of accounting for the return service as a performance obligation it could be argued that:

(a) The right of return is reflected in the transaction price of the contract. This view is supported by the fact that not all contracts result in a right of return. Thus, the return right has value and the customer pays a premium for it.

(b) The return service performance obligation is functionally separable from the underlying good in the contract, and should therefore be separated from that good.

(c) If the entity does not recognize a performance obligation for the return service, it will have recognized all of the revenue and margin in the contract once it has transferred control of the good to the customer. That may not be a faithful depiction of the entity's performance under the contract.

23. However, it should also be noted that:

(a) Accounting for the return service as a performance obligation requires an entity to determine the standalone selling price of that service. In many cases, the return service is not provided as an optional extra, so there is no directly observable price for that service.

(b) In many cases, the number of returns is a very small percentage of total sales and, furthermore, that level does not vary significantly. In addition, the return period is often only for a short period (e.g., 30 days).

24. Therefore some question whether the incremental information provided to users by accounting for the return service as performance obligation justifies the complexities and costs of doing so. They argue that it should be sufficient for the entity to recognize the refund obligation as discussed above.

25. The staff thinks that this is a valid concern. However, the staff also notes that if return levels are very low, then the standalone selling price of the return service would be insignificant. Therefore, on the grounds of materiality, the entity would not have to account for a separate performance obligation.

Changes in expectations

26. In some cases, an entity's expectations about the expected number of returns may change after contract inception but before expiry of the return period.

27. The entity would therefore need to:

(a) update its estimate of expected returns;

(b) update the refund obligation to reflect the revised amount of refunds; and

(c) make a corresponding adjustment to the amount allocated to the performance obligations (because the number of contracts that are expected not to fail has changed).

28. In cases in which the entity has not recognized a performance obligation for the return service, the effect of the adjustment would be to increase (decrease) the refund liability and decrease (increase) revenue.

EXAMPLE 3: Change in expectations

Assume the same facts as in Example 1.

HenryCo also determines that the return service performance obligation would be immaterial.

At contract inception, HenryCo records the sale of goods as follows:

dr Cash	10000	
cr Revenue		9800
cr Refund Obligation		200
dr Cost of goods sold	2000	
cr Inventory		2000

Suppose that shortly after contract inception, HenryCo estimates that the probability of a customer returning the good has increased to 3%. Accordingly:

- the revised number of contracts expected to fail is 3
- the revised refund obligation per contract is CU300, (3 x CU100).

To record the change in expectations after contract inception:

dr Revenue	100	
cr Refund Obligation		100

To record the refunds:

dr Refund Obligation	300	
cr Cash		300

Returned inventory

29. Thus far the examples within this paper have assumed that returned goods cannot be resold by the entity. However, in many cases products are returned by the customer in saleable condition. This raises the question of whether and how

those products expected to be returned should be recognized on the entity's statement of financial position.

30. The staff thinks that when customers buy goods with a right of return, they obtain control of those goods, even though they have they option to return them. This is because the customers direct the use and receive the benefit from those goods. Hence, an entity does not have an asset of inventory for the products expected to be returned by customers.

31. Nonetheless, if the entity is required to refund the consideration to a customer, it has a contractual right to recover the good from the customer. In other words, the customer is entitled to a refund only if it returns the good.

32. Hence, the staff thinks there are two alternatives for reflecting the entity's right to recover the good.

Net the right against the refund obligation

33. In this approach, an entity would reduce the refund obligation by the value of the inventory expected to be returned and recognize a corresponding reduction to cost of sales. The refund obligation would therefore reflect the net outflow of economic benefits from the entity (that is, the gross cash flows to the customer less the inventory expected to be returned in exchange).

Recognize the right as a separate asset

34. In this approach, an entity would recognize its right to recover the inventory as a separate asset (again with a corresponding reduction to cost of sale). This asset could be viewed similarly to a reimbursement right in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. There an entity recognizes an asset for any reimbursement to which it is entitled when it settles a provision (liability).

35. In both approaches, the right to recover the good would be measured at the entity's original cost of that good (that is, its former carrying amount in inventory).

36. The staff thinks that the approach of recognizing the right as a separate asset results in greater transparency. For example, it will ensure that the asset is considered for the purpose of impairment testing, and may also provide useful information for users.

Staff recommendations and question for the Boards

Question 1 Accounting for the sale of goods with right of return
The staff recommends that: (a) An entity should not recognize revenue for the goods that are expected to be returned, but instead should recognize a refund liability for the expected (probability-weighted) amount of refunds to customers. (b) Subsequently an entity should update the refund liability for changes in expectations about the amount of refunds and make a corresponding adjustment to the amount allocated to the performance obligations. (c) An entity should recognize an asset (and corresponding adjustment to cost of sales) for its right to recover goods from customers on settling the refund liability, initially measured at the original cost of the goods (that is, the former carrying amount in inventory). (d) The promised return service meets a definition of a performance obligation. However an entity should allocate a portion of the transaction price to that performance obligation only if it is material. Do the Boards agree?