STAFF PAPER

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Project	FASB-IASB Joint Transition Resource Group for Revenue Recognition
Paper topic	Accounting for Restocking Fees and Related Costs

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Background and Purpose

1. Some stakeholders informed the staff that there are questions about the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the "new revenue standard"), for restocking fees and related costs for expected product returns.
2. Entities sometimes charge customers a "restocking fee" when a product is returned. Restocking fees typically are charged to compensate entities for various costs associated with a product return, such as shipping costs and repacking costs. Restocking fees also may be charged to compensate an entity for the reduced selling price that an entity may charge other customers for a returned product.
3. Some stakeholders raised questions about the accounting for restocking fees and related costs. This paper summarizes the questions that were reported to the staff. The staff plan to ask the members of the TRG for their views on this topic.

Accounting Guidance

4. The relevant accounting guidance has been included in Appendix A of this paper.

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Implementation Issues

5. This section of the paper includes questions that have been brought to the staff's attention about the accounting for restocking fees and related costs. The following example has been included to facilitate a discussion among members of the TRG:

> Entity enters into a contract with Customer to sell 10 widgets for $100 each. The cost of each widget is $75. Customer has the right to return a widget, but will be charged a restocking fee of 10% (that is, $10 per widget). Entity expects to incur restocking costs of 5% (that is, $5 per widget). Entity concludes that, due to the existence of a return right, the consideration promised in its contract with Customer includes a variable amount. Entity uses the expected value method for estimating the variable consideration and estimates that 10% of widgets will be returned and that it is probable that returns will not exceed 10%. Entity expects that the returned widgets can be resold at a profit.

Issue 1: How should Entity account for restocking fees for widgets expected to be returned?

6. The staff is aware of the following three views reported by stakeholders:

   (a) *View A*—Restocking fees for widgets expected to be returned should be included as part of the transaction price when control transfers.

   (b) *View B*—Restocking fees for widgets expected to be returned should be excluded from the transaction price. Rather, Entity should recognize the restocking fees as revenue when the widgets are returned.

   (c) *View C*—Restocking fees for widgets expected to be returned create a put option at a price that is lower than the original selling price of the product and should be treated as a lease.

View A

7. Entity recognizes revenue of $910 [(9 widgets expected <u>not</u> to be returned * $100 selling price) + (1 widget expected to be returned * $10 restocking fee)] and a refund liability of $90 [1 widget expected to be returned * ($100 selling price - $10 restocking fee)] when control of the widgets transfer to Customer.

8. Proponents of *View A* think that including a restocking fee in an entity's estimate of variable consideration is most consistent with the guidance in paragraphs 606-10-32-5 through 32-6 [B23-B24][1] that requires an entity to estimate the amount of consideration to which it expects to be entitled. That is, proponents of *View A* think that Entity is entitled to a $10 restocking fee in the event of a widget return and, therefore, should be considered when estimating variable consideration. As a result, proponents of *View A* think Entity's contract with Customer includes only $90 of variable consideration.

9. While it results in the same outcome, other proponents of *View A* do not think of the restocking fee as a reduction in the estimate of variable consideration, but rather as a fixed component of the transaction price. That is, some proponents of *View A* observe that when control of the widgets transfer to Customer, the $10 restocking fee is an amount that Entity is entitled to, regardless of whether Customer returns the widgets.

10. Similarly, proponents of *View A* think that a restocking fee should be excluded from an entity's estimated refund liability. That is, proponents of *View A* think the guidance on refund liabilities in paragraph 606-10-32-10 [55] would require Entity to exclude the $10 restocking from its estimated refund liability because Entity expects to be entitled to that amount in the event of a widget return.

11. Proponents of *View A* also think that a product return subject to a restocking fee is no different than a partial return right and should be accounted for in the same manner. For example, proponents of *View A* think that the return right illustrated in the Example above should be accounted for no differently than if Entity had offered Customer a refund of only 90% of the selling price and did not charge a restocking fee (that is, Entity would assess whether $90 of variable consideration should be included in the transaction price).

View B

12. Entity recognizes revenue of $900 (9 widgets expected <u>not</u> to be returned * $100 selling price) and a refund liability of $100 (1 widget expected to be returned * $100 selling price) when control of the widgets transfer to Customer. Entity would

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[1] IFRS 15 references are included in "[XX]" throughout this paper.

separately recognize $10 of revenue for the restocking fee when Customer returns a widget and when the related restocking costs are incurred.

13. Proponents of *View B* think that excluding a restocking fee from the transaction price is most consistent with the guidance in paragraphs 606-10-55-23(a) [B21(a)] that prohibits an entity from recognizing revenue for products expected to be returned. That is, proponents of *View B* think that Entity should exclude the $10 restocking fee from the transaction price because they think that the restocking fee represents revenue associated with a widget expected to be returned. That is, proponents of *View B* think that the return of a widget is a separate transaction and the restocking fee assessed should be recognized separately when the widget is returned.

14. Similarly, Proponents of *View B* think that excluding a restocking fee from an entity's estimate of variable consideration is consistent with the guidance in BC364 that states that the Board decided that an entity should not recognize revenue for the sales that are expected to fail as a result of customers exercising their return rights.

View C

15. Entity evaluates the guidance in paragraph 606-10-55-72 [B70] and accounts for the widget transaction as a lease in accordance with Topic 840, Leases [IAS 17 *Leases*].

16. Proponents of *View C* think that a restocking fee represents a rental charge for use of a specified asset over an estimated holding period and, therefore, should be treated as a lease. That is, proponents of *View C* think that Entity has given Customer the option to put widgets back to Entity in exchange for a restocking fee that is less than the selling price of the widget.

Staff Analysis

17. The staff think that *View A* is most appropriate because *View A* is most consistent with how the staff think an entity should account for restocking costs (discussed further in Issue 2). The staff also think that a returned product subject to a restocking fee is no different than a partial return right and, therefore, should be accounted for similarly. That is, the staff think that a restocking fee should be included in the transaction price if an entity is entitled to that amount, regardless of whether that amount is explicitly stated as a restocking fee in the contract or the entity offers its

customers less than a full refund for product returns in order to compensate the entity for various costs associated with a product return.

18. The staff do not think that View B is appropriate because it would result in accounting that is inconsistent with (a) the staff's view on the accounting for restocking costs (discussed further in Issue 2) and (b) the accounting for a partial return, which the staff think is economically similar to an arrangement that includes restocking fees.

19. The staff do not think that *View C* is appropriate. Paragraph 606-10-55-72 [B70] would require an entity to account for a put option as a lease, only if the put option provides a customer with a significant economic incentive to exercise that right. The staff do not think that a right that permits a customer to return a product in exchange for a restocking fee provides a customer with a significant economic incentive to exercise the right.

Issue 2: How should Entity account for restocking costs for expected widget returns (for example, estimated shipping or repackaging costs)?

20. The staff is aware of the following three views:

    (b) *View A*—Restocking costs should be accrued when control of the widgets transfer.

    (d) *View B*—Restocking costs should be recognized when a widget is returned and the costs associated with that return are incurred.

    (e) *View C*—Costs to recover expected widget returns should be recognized when incurred, unless there is an expected impairment of the returned widget.

View A

21. Proponents of *View A* think that the guidance in paragraph 606-10-55-27 [B25] requires Entity to accrue for restocking costs for expected widget returns at the time the widget is initially transferred to Customer. That guidance states that an asset recognized for an entity's right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover the product (including potential decreases in the value to the entity of returned products).

That is, proponents of *View A* think that when Entity first sells a widget to Customer, it should reduce its asset to recover returned widgets from Customer by an amount equal to its estimated costs to recover expected widget returns.

22. Because proponents of *View A* think that the guidance in the new revenue standard is clear that restocking costs should be accrued upon sale of a product, proponents of *View A* also think that restocking fees should be included in Entity's estimate of the transaction price.

View B

23. Proponents of View B think that the guidance in paragraph 606-10-55-27 [B25] was not intended to address restocking costs, but rather addresses the potential impairment of a returned product. Proponents of View B think that restocking costs should be recognized when incurred. That is, proponents of *View B* think that Entity should not recognize restocking costs until Customer returns a widget and those restocking costs are incurred, unless there is an expected impairment of the returned widget.

24. Because proponents of *View B* think that restocking costs should not be recognized until incurred, proponents of *View B* also think that restocking fees should be excluded from Entity's estimate of the transaction price and should be recognized only when the widget is returned.

View C

25. Proponents of *View C* think that restocking costs should be accrued only if there is an expected impairment of the returned product. For example, proponents of *View C* interpret paragraph 606-10-55-27 [B25] to suggest that Entity has zero "net restocking costs" to accrue because the $10 restocking fee assessed by Entity is greater than its estimated restocking costs of $5.

Staff Analysis

26. The staff agree with *View A* because paragraph 606-10-55-27 [B25] requires that any expected costs to recover returned products should be accrued by reducing the value of the asset recorded for the right to recover those products. Accruing costs when the widget is transferred to the customer also is most consistent with the timing of when the staff think the restocking fees should be recognized.

Question for the TRG Members
1. Do the TRG members agree with the staff's interpretations in this paper?

Appendix A: Relevant Accounting Guidance

Determining the Transaction Price

27. Paragraph 606-10-32-2 [47] states that the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). To determine the transaction price, an entity should consider the effects of variable consideration, constraining estimates of variable consideration, the existence of a significant financing component, noncash consideration, and consideration payable to the customer.

28. Paragraph BC186 explains that the transaction price should include only amounts (including variable amounts) to which the entity has rights under the present contract. For example, the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services or from future change orders. Until the customer exercises the option or agrees to the change order, the entity does not have a right to consideration.

Variable Consideration

29. Paragraph 606-10-32-5 [50] states that if the consideration promised in a contract includes a variable amount, an entity is required to estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

30. Paragraph 606-10-32-6 [51] states that an amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. Paragraph BC191 explains that consideration can be variable even in cases in which the stated price in the contract is fixed. This is because the entity may be entitled to the consideration only upon the occurrence or nonoccurrence of a future event. Consider, for example, a fixed-price service contract in which the customer pays upfront and the terms of the contract provide the customer with a full refund of the amount paid if the customer is dissatisfied with the service at any time. In those cases, the consideration is variable

because the entity might be entitled to all of the consideration or none of the consideration if the customer exercises its right to a refund.

31. Paragraph 606-10-32-7 [52] states that the variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

   a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.
   b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

32. Paragraph 606-10-32-8 [53] states that an entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

   a. The expected value—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
   b. The most likely amount—The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

33. Paragraph 606-10-32-9 [54] states an entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecast) that is reasonably

available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

34. Paragraph BC365 explains that the Boards decided that in determining the amount of revenue to recognize (that is, the amount of the refund obligation), an entity should use the principles for recognizing and measuring variable consideration. Using those principles, an entity would recognize revenue only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the right of return is subsequently resolved. When the entity determines that it cannot recognize all of the consideration received as revenue for the sale of goods with a right of return, the entity would recognize some of the consideration received as a refund liability.

Refund Liabilities

35. Paragraph 606-10-32-10 [55] states that 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. 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**). 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. To account for a refund liability relating to a sale with a right of return, an entity shall apply the guidance in paragraphs 606-10-55-22 through 55-29 [B20-B27].

36. Paragraph BC364 explains that in relation to performance obligations to provide customers with goods, the Boards decided that, in effect, an entity has made an uncertain number of sales. This is because it is only after the return right expires that the entity will know with certainty how many sales it has made (that is, how many sales did not fail). Consequently, the Boards decided that an entity should not recognize revenue for the sales that are expected to fail as a result of customers

exercising their return rights. Instead, the entity should recognize a liability for its obligation to refund amounts to customers.

Sale with a Right of Return

37. Paragraph 606-10-55-22 [B20] states that 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 receive any combination of the following:

    a. A full or partial refund of any consideration paid
    b. A credit that can be applied against amounts owed, or that will be owed, to the entity
    c. Another product in exchange.

38. Paragraph 606-10-55-23 [B21] states that 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:

    a. **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)
    b. A refund liability
    c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

39. Paragraph 606-10-55-24 [B22] states that an entity's promise to stand ready to accept a returned product during the return period should not be accounted for as a performance obligation in addition to the obligation to provide a refund.

40. Paragraph 606-10-55-25 [B23] states that an entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 [47-72] (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 [56-58]) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but

should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the **transaction price** and, therefore, in the amount of revenue recognized.

41. Paragraph 606-10-55-26 [B24] states that 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).

42. Paragraph 606-10-55-27 [B25] states that an asset recognized for an entity's right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity should update the measurement of the asset arising from changes in expectations about products to be returned. An entity should present the asset separately from the refund liability.

43. Paragraph 606-10-55-28 [B26] states that 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 for the purposes of applying the guidance in this Topic.

44. Paragraph 606-10-55-29 [B27] states that contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties in paragraphs 606-10-55-30 through 55-35 [B28-B33].

A Put Option

45. Paragraph 606-10-55-72 [B70] states that if an entity has an obligation to repurchase the asset at the **customer's** request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity

consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 840 [IAS 17] on leases unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 840-40.