

New on the Horizon:

Revenue recognition for food, drink and consumer goods companies

August 2010

In June 2010 the IASB¹ and the FASB² published a joint exposure draft on revenue recognition that could significantly impact the accounting for, and the presentation of, revenue by food, drink and consumer goods (FDCG) companies if implemented in its current form.

Exposure Draft ED/2010/6 *Revenue from Contracts with Customers* (the ED) is part of the Boards'³ ongoing project to develop a new, converged accounting standard on revenue recognition. The ED contains proposals on how to measure the consideration in a sales contract, how to allocate that amount to the performance obligations in a sales contract and when to recognise revenue, and proposes additional disclosures. The ED also proposes guidance about how contract costs should be treated.

Sales is a key financial measure for any consumer-facing organisation, and any change from current accounting standards is not just an accounting issue, but a business issue that is expected to capture the attention of those right across the organisation, including the CEO.

The current IFRS for revenue recognition, IAS 18 *Revenue*, is quite general. This can lead different FDCG companies to apply different accounting practices to economically similar transactions, e.g. accounting for product placement services. US GAAP, on the other hand, has over 180 pieces of literature and numerous industry-specific models for revenue recognition. The application of this proposed standard would provide for a more consistent comparison of companies' performance across the FDCG industry and between industry sectors. However, differences in the determination of some revenue-based performance measures (such as profit margins) would likely continue to exist between companies accounting under IFRSs and US GAAP as a result of the accounting for costs that are affected by other standards for which the Boards have not developed aligned guidance, for example in the areas of inventories and internally-developed intangible assets.

The Boards' proposals, on which comments are due by 22 October 2010, are discussed in detail in KPMG's publication [New on the Horizon: Revenue from Contracts with Customers](#). This newsletter highlights specific issues for the FDCG sector.

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Overview of the requirements

The basic premise of the ED is that a company should recognise revenue in the amount of consideration that it expects to receive when it transfers control of goods and services to a customer; revenue would be based on the consideration that the company expects to receive from the customer. The ED proposes a five-step process in accounting for revenue:

- 1 – Identify the contract(s) with the customer.
- 2 – Identify the separate performance obligations in the contract.
- 3 – Determine the transaction price.
- 4 – Allocate the transaction price to the separate performance obligations.
- 5 – Recognise revenue when a performance obligation is satisfied.

Identify the contract(s) with the customer

Contracts would not need to be written. A contract could also be verbal or implied by a company's customary business practices. For example, any verbal promise made by a sales representative to a retailer would need to be captured and incorporated into the determination of revenue.

Identify the separate performance obligations

Within each identified sales contract, a company would identify performance obligations, which are enforceable promises to transfer goods or services to a customer. Performance obligations would be accounted for separately to the extent that they are "distinct" and are satisfied at different times. A good or service has a distinct function if it has utility either on its own or together with other goods or services that the customer has acquired from the company, or is sold separately by the company or by another company. A good or service has a distinct profit margin if it is subject to distinct risks and if the company can separately identify the resources needed to provide the good or service.

Typically FDCG companies negotiate various conditions of sale with the customer, including, but not limited to: price promotions, volume rebates, service level commitments, product placement services, rights of return and product warranties. Each element of a sales negotiation would be assessed independently to determine whether it represents a separate performance obligation. As sales contracts often include several of these elements, the impact on revenue recognition could be significant.

Determine the transaction price

The role of estimation by management would substantially increase under the proposals. The transaction price, which drives the amount of revenue to be recognised, would be the probability-weighted amount of consideration that a company receives or expects to receive from the customer in exchange for transferring goods or services.

Factors to consider when determining the transaction price include:

- estimates of any variable consideration;
- the effect of the customer's credit risk;

- the effect of the time value of money if a contract includes a material financing component;
- the fair value of non-cash consideration; and
- whether a certain amount of consideration payable to the customer is a discount or a payment.

A company would reflect variable consideration, for example prices that depend on meeting agreed service levels, in the transaction price only to the extent that it can be reasonably estimated by reference to relevant experience. If a company cannot reasonably estimate an element of variable consideration, then it would not include that part of the total consideration in the transaction price recognised until it can be reasonably estimated. At the point in time at which such amounts subsequently can be reasonably estimated, the additional amount would be allocated to all performance obligations consistent with the original transaction price allocation.

Allocate the transaction price to the performance obligations

Companies would allocate the transaction price to the separate performance obligations on the basis of their relative stand-alone selling prices.

Recognise revenue when a performance obligation is satisfied

The allocated transaction price would be recognised as revenue as the related performance obligation is satisfied, i.e. when control of the promised goods or services is transferred to the customer. Transfer of control may occur at a point in time or on a continuous basis.

Industry-specific application

In the following discussion, we consider some potentially significant impacts that implementation of the ED would have on revenue recognition for FDCG companies.

Payments to customers

FDCG companies often make payments to their distributors and retailers for services such as product placement or the in-store promotion of a new product (i.e. a distinct service with a distinct profit margin). In such cases, management would be required to determine the fair value of services provided by the customer that are distinct from the customer's purchase of the seller's products. Payment for such services would be recognised at the fair value of the service provided in accordance with the company's usual accounting policy for such purchases. If such payments to customers exceed the fair value of the service provided, then any excess would be presented as a reduction in revenue, a shift from current IFRS practice for a number of companies. US GAAP preparers, on the other hand, may find that certain payments previously classified as a reduction in revenue would now be presented as expenses.





Rights of return

The ED would not change the amount of revenue to be recognised in respect of goods expected to be returned by FDCG companies; revenue would not be recognised for such goods. However, the accounting in the statement of financial position would change, with an asset recognised for the right to recover goods measured at cost less adjustments for impairment, and a liability booked for obligations to provide refunds and credits to customers. The asset and liability would be remeasured at each reporting date with adjustments thereto affecting revenue and cost of goods sold.

Product warranties

Some companies would experience potentially significant changes in their management of warranties. Currently, many warranty obligations are accounted for through full recognition of revenue and an accrual of estimated costs. Under the proposals, regardless of the *type* of warranty obligation, the warranty obligation would result in a deferral of revenue rather than an accrual of estimated costs. If an FDCG company provides a warranty for latent defects (those in existence at the time of sale), then the revenue attributed to the warranty would be deferred and recognised as those defects are remedied. If a latent defect warranty is for product replacement, then the revenue related to products expected to be replaced would be deferred; if it is a repair warranty, then the portion of the transaction price attributed to components to be repaired would be deferred. If a warranty covers defects arising after sale, then the revenue attributable to that performance obligation would be recognised over the period of the warranty.

Service level commitments

FDCG companies often enter into service level commitments with retailers to commit to product availability, product quality, on-time deliveries and accurate invoicing. If FDCG companies fail to meet agreed key performance indicators, then penalties can be assessed by retailers. Under-performance against a service level agreement may need to be factored into the determination of the contract price.

How should FDCG companies account for such penalties? The ED proposes that a company evaluate whether it receives any identifiable good or service in return for such a payment. If no distinct good or service is received, then the penalty would be treated as a reduction of the contract amount. Periodic true-ups for actual deductions agreed and settled would similarly be reflected as adjustments to revenue.

Slotting fees

Slotting fees are those payments made to a retailer in exchange for product placement in-store. IAS 18 is silent on how to account for slotting fees. Some FDCG companies expense these charges as a marketing cost, on the basis that the prominent display of their products in retail shops increases product visibility and therefore is a form of marketing its products to the consumer. Under US GAAP, such payments are presumed to be a reduction in revenue.

The proposed standard would require FDCG companies to assess whether payments made to the customer are a reduction in the transaction price, a payment for a distinct good or service, or a combination of both.

Example: Slotting fees

A coffee company sells 500 jars of coffee to a retailer for 5,000, also agreeing to pay the retailer 1,000 for slotting fees in return for the retailer stocking, displaying and supporting the product. The coffee company estimates the fair value of the product placement service to be 750.

Despite the fact that the retailer does not sell the product placement service separately, i.e. without related products, the coffee company determines that it is receiving a distinct service since that service has a distinct function and a distinct profit margin. As such, the coffee company recognises an expense for the fair value of the product placement service of 750. The remaining 250 (1,000 payment to retailer - 750 fair value of the service) would result in a reduction of the transaction price. The coffee company would recognise revenue of 4,750 (5,000 - 250) when the retailer obtains control of the jars of coffee.





This proposed accounting differs from existing US GAAP and provides more extensive guidance than IAS 18; accordingly, this proposal would result in a change in practice for many FDCG companies. The application of this concept may also pose practical challenges for companies. Management would be required to identify payments to customers (not just for slotting fees) and assess them to determine whether they are made for distinct goods or services or are a reduction of the contract amount. If management determines that a payment made to a customer is a payment for a distinct good or service, then management would estimate its fair value, which may not necessarily equal the amount paid, to determine the amount to be accounted for as payment for that good or service, with any excess amount being treated as a reduction in revenue.

Early settlement discounts

Early settlement discounts are discounts offered by FDCG companies to encourage their customers to pay their invoices early, to improve cash flows and to reduce the risk of outstanding invoices becoming bad debts. Such discounts would be reflected as a reduction in revenue under the proposals by estimating the discounts that customers are likely to take upon entering into the sales contract. The related receivable would be remeasured at each reporting date with any subsequent adjustments recognised through revenue and accounts receivable.

Deductions taken by retailers

Retailers sometimes take deductions from the amounts invoiced by FDCG companies when making payments, either in response to the FDCG company's under-performance against service level agreements or simply the taking of an unauthorised discount.

FDCG companies would estimate the amount expected to be collected from the retailer based on their historical experience with customers or other relevant experience, including the possibility of unauthorised deductions. Such deductions also would be treated as reductions in the contract price. Periodic true-ups for actual deductions agreed and settled would be reflected as adjustments to revenue.

Customer credit risk/collectibility

The ED proposes that the estimated amount of promised consideration be adjusted to reflect the customer's credit risk when the effect is material. Different customers in different channels could have different levels of credit risk.

The seller would recognise the fair value of the receivable as revenue and present any subsequent difference arising on remeasurement of the receivable as income (not revenue) if a gain, and expense if a loss.

Consumer promotions for additional goods or services

Most manufacturers use direct-to-consumer promotions to increase the likelihood that consumers will select their product over a competitor's. These promotions typically include offers such as rewards or points through a loyalty scheme or the provision of a future discount through vouchers or coupons.

Under the ED, an option to acquire additional goods or services in the future gives rise to a separate performance obligation if the option provides a material right to the consumer that the consumer would not have otherwise received without entering into the contract. If the option represents a material right, then the consumer is, in effect, paying the company in advance for future goods or services and the company would recognise revenue for these performance obligations only when they are satisfied at a future date or when the option expires.

Management would be required to estimate the success of such promotions, i.e. the utilisation of vouchers and coupons by consumers. When estimates cannot be made reliably, revenue would be deferred until actual results are known.

This guidance will be familiar to FDCG companies reporting under IFRSs, which have applied IFRIC 13 *Customer Loyalty Programmes* for some time. This may, however, represent a change in accounting practice for FDCG companies reporting under US GAAP.

Example: Discount vouchers

An electronics company sells a camera for 500. On the outside of the camera box, the company has placed a 40 percent discount voucher for any future purchases of camera accessories (e.g. lenses, flashes) made in the next 90 days.

The company determines that the voucher represents a material right to the customer (i.e. an option to purchase additional goods below their stand-alone selling price), and it is therefore identified as a separate performance obligation.

Historically, 80 percent of the vouchers placed on camera boxes by the company have been redeemed and, on average, the customer has purchased an additional 50 of camera accessories with the voucher.

As such, the stand-alone selling price of the voucher is estimated at 16 (50 average purchase price x 40% discount x 80% likelihood of redemption).

On the date of sale, the company would recognise 484.50 as revenue: $500 \times (500 / (500 + 16))$. The remaining 15.50 would be deferred until the voucher is redeemed or expires: $500 \times (16 / (500 + 16))$.

If the voucher did not have an expiration date, then the electronics company would reassess the likelihood of the voucher being redeemed at each reporting date.





Consignment arrangements

Some FDCG companies enter into consignment arrangements with dealers or distributors in an effort to move their inventory closer to the point of sale or to provide their customers with access to a wider range of inventory than is typically available. The timing of revenue recognition for consignment or other sell-through arrangements may change under the ED. Revenue would be recognised in accordance with the ED when control of the goods has passed from the seller to its customer. Sales contracts would need to be assessed on a case-by-case basis, assessing the factors influencing control. For example, if the FDCG company has the right to recall its products from a distributor or retailer at any stage prior to sale to the end customer, then control has not passed and revenue would not be recognised before such sale to the end customer. However, if only the distributor or retailer has the option to send goods back to the FDCG company, then, subject to the impact of estimated returns and provided that other criteria are met, control has passed and revenue would be recognised.

Bill-and-hold arrangements

FDCG companies may enter into bill-and-hold transactions with their customers whereby the customer is billed for the product but does not take physical possession of the goods. In such cases, FDCG companies would recognise revenue when control of the goods has passed to the customer. For a customer to have obtained control of a product in a bill-and-hold arrangement, and therefore for revenue to be recognised, four criteria would need to be met:

- 1 the customer must have requested the contract to be on a bill-and-hold basis;
- 2 the product must be identified separately as the customer's;
- 3 the product currently must be ready for delivery at the location and time specified, or to be specified, by the customer; and
- 4 the company cannot use the product or sell it to another customer.

Relevant other factors also would need to be considered, such as whether the goods are ready for delivery and bespoke to the customer.

Licensing and rights to use intellectual property

Revenue recognised under licence and royalty arrangements may change from existing practice under both IFRSs and US GAAP. FDCG companies would be required to evaluate whether a right to use the company's intellectual property is granted for substantially all of such property's economic life; if so, then such an arrangement would be considered a sale. If such a right to use is granted for less than substantially all of the economic life of the related intellectual property, then the FDCG company would be required to evaluate whether it is granted on an exclusive or non-exclusive basis. If a licence is granted on an exclusive basis, then the company has a performance obligation over the licence period and would recognise revenue over the term of the licence. If a licence is granted on a non-exclusive basis, then there is no ongoing performance obligation and revenue would be recognised when the customer is able to use or benefit from the right.

For example, an FDCG company may enter into a contract that grants a customer the exclusive right to manufacture and sell a product in a specified region for five years. The customer is obliged to pay a fixed upfront fee and an ongoing

royalty of one percent. Since the rights are exclusive to a specified region, the company satisfies the performance obligation over the five-year term of the contract and the upfront fee would be deferred and recognised as revenue together with the ongoing royalties over the five-year period of the licence.

Other matters

The ED proposes a range of quantitative and qualitative disclosures intended to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The ED proposes that companies provide increased disclosure around the recognition of revenue, including quantitative and qualitative information about:

- its contracts with customers; and
- the significant judgements, and changes in judgements, made in applying the proposed standard to those contracts.

The Boards propose that the standard be applied retrospectively. An adoption date has yet to be determined.

Wider implications of the proposed standard

In addition to the proposed standard's impact on sales, there could be broader – non-financial reporting – implications to consider.

Organic Growth

Many FDCG companies explain their performance both in terms of organic growth and inorganic growth, often separating out organic growth by changes in volumes and changes in pricing. Therefore, modifications to the measurement of revenues could have an impact on organic growth calculations through the pricing component and the possible deferral of sales under the proposed standard. In addition, the volatility of organic growth calculations could increase as the pricing element is affected by more factors than, and differently from, before.





Margins

Margins also could be impacted by the application of the proposed standard as a result of both the potential deferral of revenue under the proposed standard (e.g. warranties), and/or changes in the measurement of revenue (e.g. accounting for payments to customers). Changes in reported margins would also need to be explained to stakeholders.

Managing stakeholder expectations

All stakeholders need to understand how the proposed accounting changes would impact the way in which the company is reporting its performance, and why. For example:

- Executive management would need to manage the investor community's expectations, explain why the company's revenues are changing, and respond to any questions about revenue and margin performance in comparison to competitors.
- Sales executives would need to understand how their negotiations with retailers and the agreements they enter into would affect sales and margins as reported externally. Whether a company places greater emphasis on sales growth or margins from a performance perspective could alter how sales executives approach their negotiations.
- Consideration would need to be given as to how revenues are measured and assessed internally. If a non-IFRS/non-GAAP measure is used, then what will be the basis for presenting segmental performance?

Clear communication with the investor community will be of paramount importance for CEOs and CFOs when reporting changes in the basis of preparation of their results to the market

Existing contracts

It is common for certain types of contracts to include sales-based performance criteria, and such contracts would need to be reviewed to ensure that FDCG companies' rights and obligations remain the same with a new measurement basis for revenue.

For example, if a company is subject to debt covenants, then the loan agreement should be reviewed to ensure that any references to revenue are evaluated and that the covenants are modified and appropriate actions are considered to mitigate the risk of default. Additionally, licensing arrangements, both internal and external, are often based on royalty rates calculated as a percentage of sales. In a licensing agreement, sales would need to be redefined to ensure that the level of royalty income remains in line with that originally intended on entering into the contract.

Sales and marketing systems

To ensure compliance with the proposals, FDCG companies would need to thoroughly evaluate their relationship with every customer. Companies would need to incorporate all elements of their negotiations for sales into their accounting for revenue. This means that all deals agreed for price promotions, volume rebates, service level commitments, product placement services, rights of return, or product warranties, or indeed any term or condition to incentivise a sale, would explicitly affect the revenue line.

Different customers in different channels may of course have different terms and conditions; large format retailers, convenience stores, distributors, business-to-business, hotels, restaurants, caterers, and consumers direct. And companies would need to ensure that their systems are capable of capturing and monitoring all terms and conditions with customers, linked to the sales that they support.

Companies should be evaluating process and systems requirements now – to identify any modifications that will be required to existing systems – or even whether a new system for managing sales and marketing may be required.



Abbreviations

- 1 IASB: International Accounting Standards Board
- 2 FASB: US Financial Accounting Standards Board
- 3 Boards: The IASB and the FASB

Global contacts

Willy Kruh

Global Sector Head
KPMG in Canada
+1 416 777 8710
email: wkruh@kpmg.ca

Ladislava Klein

Global Tax Lead
KPMG in Germany
+49 221 2073 1921
email: klein@kpmg.com

Mark Baillache

Global Audit Sector Lead
KPMG in the UK
+44 20 73114716
email: mark.baillache@kpmg.co.uk

Katie Bishop

Global Executive
KPMG in the UK
+44 207 311 6296
email: katie.bishop@kpmg.co.uk

Julian Thomas

Global Advisory Lead
KPMG in the UK
+44 20 76943401
email: julian.thomas@kpmg.co.uk

Elaine Pratt

Global Marketing & Communications
KPMG in Canada
+1 416 777 8195
email: ep Pratt@kpmg.ca

Country contacts

Americas

Americas and the US

Patrick Dolan
+1 312 665 2311
email: patrickdolans@kpmg.com

France

Eric Ropert
+33 1 55687190
email: eropert@kpmg.fr

The Netherlands

Rene Aalberts
+31 20 656 8046
email: reneaalberts@kpmg.com

Asia Pacific

AsPac and China/Hong Kong

Nick Debnam
+852 2978 8283
email: nick.debnam@kpmg.com.hk

Brazil

Carlos Pires
+55 11 2183-3148
email: capires@kpmg.com.br

India

Nandini Chopra
+91 223 090 2603
email: nandinichopra@kpmg.com

South Africa

Daryll Jackson
+27 (11) 647-6895
email: daryll.jackson@kpmg.co.za

Australia

David Rogers
+61 (2) 9335 8188
email: drogers@kpmg.com.au

Europe, Middle East & Africa

Denmark

Henrik Larsen
+45 38 183 718
email: hlarsen@kpmg.dk

Italy

Wah Meng Gan
+39 02 67631
email: wgan@kpmg.it

United Kingdom

Ian Starkey
+44 20 73118203
email: ian.starkey@kpmg.co.uk

Japan

Tatsunaga Fumikura
+81 (3) 3266 7004
email: tatsunaga.fumikura@jp.kpmg.com

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