

Revenue Recognition Applied: Manufacturing & Distribution



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Rights of Return

As nonpublic companies are analyzing their contracts to ensure compliance with ASC 606 *Revenue from Contracts with Customers*, the internal accounting departments at these entities are having to gain a better understanding of what promises the sales departments are making to customers. One of these promises might be a right of return. While this is not a new concept in the accounting standards, ASC 606 has certainly caused companies to carefully analyze their contracts to determine if a right of return exists.

Background

A right of return occurs when an entity offers their customer a right to return the products they purchase for (a) a full or partial refund of any consideration paid, (b) a credit to be applied against amounts owed, or (c) exchange for another product. A right of return can come in many forms, such as a right to return the product for any reason, a right to return the product if it becomes obsolete, a right to return products upon termination of an agreement, etc. In the instance when a customer may return a defective product in exchange for a functioning product, this is not considered a right of return but should be evaluated with the warranty guidance.

The right of return can be explicitly stated in the contract or it can be implicit in that it is in accordance with the entity's customary business practices (such as what is referenced on the company's website) or a promise made during the sales process. Thus, it is becoming more important for the accounting and sales departments to communicate what promises are being made to customers.

A right of return does not create a separate performance obligation. Instead, it affects the estimated transaction price of the goods transferred and is considered variable consideration.

To determine the transaction price for goods transferred, an entity should consider the effects of a right of return. Revenue should be recognized for the products in the amount of consideration the entity expects to receive and, therefore, in simple terms, revenue should not be recognized for the products expected to be returned. Instead, a refund liability would be recognized for the portion of the revenue expected to be returned. Additionally, an asset and corresponding adjustment to cost of sales for its right to recover returned products from the customer should be recorded.

The right of return should be estimated in the same way as other variable consideration under ASC 606. The entity should estimate the amount of consideration expected to be received for the transfer of the goods to the customer. This would include the transaction price less any amounts expected to be credited or refunded for products returned.

This can be calculated using one of two methods (1) the expected value or (2) the most likely amount.

The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. The most likely amount is the single most likely amount in a range of possible consideration amounts or the single most likely outcome of the contract. However, an entity shall only include in the transaction price some or all variable consideration estimated only to the extent that it is probable a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. Thus, management should consider all available information when estimating its expected returns.

The refund liability should be estimated at each reporting date and reflect any changes in the estimate of returns with a corresponding adjustment to revenue. Thus, a refund liability represents the consideration the entity does not expect to receive as it will be refunded to the customers.

The right to recover returned product assets should also be estimated at each reporting date and reflect any changes in the estimate with a corresponding adjustment to cost of sales. The right to recover returned product assets represents the inventory or goods to be received back from the customer. It should be measured at the carrying amount of the goods at the time of sale, less any expected costs to recover the goods, including potential decreases in the value of the returned products.

Example

1st Quarter

For the quarter ended March 31, 20XX, Company sells 1,000 units of product A to various distributors for \$10 per unit. The Company's cost of each product is \$5. The Company allows the distributors to return any products for up to 120 days after the distributor has obtained control of the product.

The Company will apply the guidance of ASC 606 to the portfolio of contracts with distributors because it reasonably expects that the effect on its financial statements, from applying the guidance to the portfolio, would not differ materially from applying the guidance to the individual contracts within the portfolio.

Since the contract allows the distributors to return products, the consideration received from the distributors is variable and, to estimate the variable consideration, the Company chooses to use the expected value method. The Company estimates 910 of the units will not be returned.

The Company then considers the guidance in ASC 606 associated with constraining estimates to determine that a significant reversal of the cumulative amount of revenue will not occur when resolved. As the Company has experience in estimating its returns for this product and, the uncertainty is expected to be resolved within the next reporting period, the Company concludes that a significant reversal will not occur as the uncertainty is resolved over the return period. Thus, the Company determines the transaction price to be \$9,100 ((1,000 units less 90 units expected to be returned) x \$10 per unit).

Additionally, the Company estimates the cost of the products to be received back as \$450 (90 units expected to be returned x \$5 cost).

The journal entries for the period ended March 31, 20XX are as follows:

#1 Accounts Receivable	\$ 10,000
Revenue	\$ 10,000
Cost of Goods Sold	\$ 5,000
Inventory	\$ 5,000

(To recognize revenue for 1,000 units of Product A shipped.)

#2 Revenue	\$ 900
Refund Liability	\$ 900

Right to Recover Returned Products	\$	450
Cost of Goods Sold	\$	450

(To record refund liability and right to recover returned products asset.)

2nd Quarter

In the second quarter, the Company sells 2,000 units of product A to various distributors. Using the same methods as noted in the 1st quarter, the Company estimates 1,820 of the units will not be returned.

The journal entries for the period ended June 30, 20XX are as follows:

#1 Accounts Receivable	\$ 20,000
Revenue	\$ 20,000
Cost of Goods Sold	\$ 10,000
Inventory	\$ 10,000

(To recognize revenue for 2,000 units of Product A shipped.)

#2 Refund Liability	\$	900
Revenue	\$	900
Cost of Goods Sold	\$	450
Right to Recover Returned Products	\$	450

(To reverse prior reporting periods refund liability and right to recover returned products asset.)

Note: This entry was recorded as the return period is 120 days and all returns would have been received for the previous reporting period.

#3 Revenue	\$ 1,800
Refund Liability	\$ 1,800
Right to Recover Returned Products	\$ 900
Cost of Goods Sold	\$ 900

(To record refund liability and right to recover returned products asset.)

Estimates

Each entity will have different promises related to their right of returns and, therefore, may require a different method of estimating. For instance, if an entity promises a right of return for a year after the date the customer obtains control, the entity may need to use historical returns to calculate the percentage of returns that occur each month after transfer to estimate returns. Or the entity could use annual historical percentages to estimate the returns that occur after each calendar year. Each entity will need to evaluate the best method for estimating the refund liability at each reporting period if using the portfolio approach.