Revenue recognition – full speed ahead
Retail and Consumer industry supplement

Overview
The accounting for revenue recognition in the retail and consumer (R&C) sector is covered by multiple pieces of literature under IFRS and US GAAP. The existing general revenue recognition model for product sales in the R&C sector is not expected to change broadly under the proposed standard, but where there is a change, it may have a significant impact. For example, certain aspects of product sales transactions in the R&C sector may be affected by the proposed standard, such as return rights, ‘sell-through’ versus ‘sell-to’ revenue recognition, customer incentives including loyalty programmes and gift cards, the licensing of intellectual property and warranties.

This ‘Practical guide to IFRS – Revenue recognition’, the examples and the related assessments contained in the industry supplements are based on the exposure draft, ‘Revenue from contracts with customers’, which was issued on 24 June 2010. These proposals are subject to change at any time until a final standard is issued. The examples reflect the potential effects of the proposed standard, and any conclusions are subject to further interpretation and assessment based on the final standard. For a more comprehensive description of the proposed standard refer to PwC’s [practical guide](#) or visit [www.ifrs.org](http://www.ifrs.org).

Right of return
Return rights are commonly granted in the R&C sector and may take the form of price protection, product obsolescence protection, stock rotation, trade-in agreements or the right to return all products upon termination of the agreement. Some of these rights may be articulated in contracts with customers or distributors; some are implied during the sales process. These rights take many forms and are driven generally by the buyer’s desire to mitigate risk related to the products purchased and the seller’s desire to promote goodwill with its customers and ensure customer satisfaction.

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<td>The sale of goods with a right of return is accounted for similarly to the current ‘failed sale’ model – that is, revenue is not recognised for goods expected to be returned, rather a liability is recognised for the expected amount of refunds to customers using a probability-weighted approach. The refund liability is periodically updated for changes in expected refunds. An asset and corresponding adjustment to cost of sales is recognised for the right to recover goods from customers on settling the refund liability, with the asset initially measured at the original cost of the goods (that is, the former carrying amount in inventory). The asset is subsequently adjusted for any impairment.</td>
<td>Returns are currently estimated based on historical experience, with an allowance recorded against sales. If an entity is unable to estimate the potential returns, revenue is not recognised until the return right lapses.</td>
<td>Revenue is typically recognised net of a provision for the expected level of returns, provided that the seller can reliably estimate the level of returns based on an established historical record and other relevant evidence.</td>
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Impact
The impact of product returns on earnings under the proposed standard will be largely unchanged from current US GAAP and IFRS accounting. However, the balance sheet will be grossed up to include the refund obligation and the asset for the right to the returned goods. If indicators of impairment exist, the asset is assessed for impairment.

Management will use a probability-weighted approach to determine the likelihood of a sales return under the proposed standard.
Example 1 – Right of return as a separate performance obligation

**Facts:** A retailer sells 100 mobile phones for C100 each. The mobile phones cost C50 and include a return right for 180 days. The retailer determined that the probability of a sales return associated with this transaction is 10%, based on historical sales patterns. In establishing the 10% return rate, the retailer estimated a 32% probability that seven mobile phones will be returned, a 40% probability that nine mobile phones will be returned, and a 28% probability that 15 mobile phones will be returned. How does management calculate and account for the obligation to accept returns?

**Discussion:** At the point of sale, C9,000 of revenue (C100 x 90 mobile phones) and cost of sales of C4,500 (C50 x 90 mobile phones) is recognised. An asset of C500 (10% of product cost, or C50 x 10 mobile phones) is recognised for the anticipated sales return, and a liability of C1,000 (10% of the sale price) is recognised for the refund obligation. The probability of return is evaluated at each subsequent reporting date. Any changes in estimates are adjusted against the asset and liability, with adjustments to the liability recorded to revenue, and adjustments to the asset recorded against cost of sales.

**Sell-through approach**

The sell-through approach is currently used for some arrangements with distributors where revenue is not recognised until the product is sold to the end customer (that is, the consumer) because the distributor may have the ability to return the unsold product, rotate older stock or receive pricing concessions.

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<td>Revenue is recognised on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or continuously over the contract period. Factors to consider include, but are not limited to:</td>
<td>The sell-through approach is common in arrangements that include dealers or distributors. Revenue is recognised once the risk and rewards of ownership have transferred to the end consumer under the sell-through approach.</td>
<td>A contract for the sale of goods normally gives rise to revenue recognition at the time of delivery, when the following conditions are satisfied:</td>
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<td>• The customer has an unconditional obligation to pay.</td>
<td>• The risk and rewards of ownership have transferred.</td>
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<td>• The customer has legal title.</td>
<td>• The seller does not retain managerial involvement.</td>
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<td>• The customer has physical possession.</td>
<td>• The amount of revenue can be reliably measured.</td>
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<td>• The customer specifies the design or function of the good or service.</td>
<td>• It is probable that the economic benefit will flow to the customer.</td>
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<td>• The costs incurred can be measured reliably.</td>
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**Impact**

The impact of the proposed standard on current accounting under both US GAAP and IFRS will depend on the terms of the arrangement. The proposed standard requires the seller to determine when transfer of control to the customer has occurred. If the customer has control of the product, including the right (but not the obligation) to put the product back to the seller at its discretion, control transfers when the product is delivered to the dealer or distributor. Expected returns, price concessions, etc, affect the amount of revenue recorded. This will change the timing of revenue recognition compared to today’s model, which focuses on the transfer of risks and rewards.

If the seller is able to require the distributor or dealer to return the product (that is, a call right), the seller controls the goods and revenue is only recognised when products are sold to a third party, similar to today’s model.

Example 2 – Sale of products to a distributor using the sell-through approach

**Facts:** A consumer-product entity uses a distributor network to supply its product to the final customer. The distributor may return unsold product at the end of the contract term. Once the products are sold to the end customer, the consumer-products entity has no further obligations with respect to the product, and the distributor has no further return rights. When does the consumer-product entity recognise revenue?
**Discussion:** Revenue is recognised once control of the product has transferred to the customer. If the distributor controls whether the goods are returned or not, the distributor is considered the ‘customer’, and transfer of control occurs when the goods are obtained by the distributor.

**Example 3 – Sale of products on consignment**

**Facts:** A manufacturer provides household goods to a retailer on a consignment basis (for example, scan-based trading). The retailer does not take title to the products until they are scanned at the register. Any unsold products are returned to the manufacturer. Once the retailer sells the products to the consumer, the manufacturer has no further obligations with respect to the products, and the retailer has no further return rights. When does the manufacturer recognise revenue?

**Discussion:** The manufacturer will need to consider whether the retailer has obtained control of the products, including whether the retailer has an unconditional obligation to pay the manufacturer for the products, absent a sale to the consumer. Revenue recognition prior to the transfer of control of the product to the consumer (that is, at the time of purchase by the consumer) might not be appropriate.

**Customer incentives**

R&C entities offer a wide array of customer incentives. Retailers commonly offer coupons, rebates issued at point of sale, free products (‘buy-one-get-one-free’), price protection or price matching programmes. Consumer-product companies commonly provide vendor allowances, including volume rebates and co-operative advertising allowances, market development allowances and mark-down allowances (compensation for poor sales levels of vendor merchandise). Consumer-product entities also offer product placement or slotting fees to retailers. There are various accounting standards that are applicable today and some diversity in practice in accounting for such incentives.

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<td>The proposed standard requires entities to identify the distinct performance obligations in an arrangement and allocate the transaction price to each performance obligation. The allocation should consider the impact of customer incentives and other discounts, which may be a separate performance obligation or may affect the total transaction price.</td>
<td>Sales incentives offered to customers are typically recorded as a reduction of revenue at the later of the date at which the related sale is recorded by the vendor or the date at which the sales incentive is offered. Volume rebates are recognised as each of the revenue transactions that results in progress by the customer toward earning the rebate occurs.</td>
<td>Sales incentives offered to customers are recorded as a reduction of revenue at the time of sale. Management uses its best estimate of expected incentives awarded to estimate the sales price. The potential impact of volume discounts is considered at the time of the original sale. For contracts that provide customers with volume discounts, revenue is measured by reference to the estimated volume of sales and the corresponding expected discounts. If estimates of the expected discounts cannot be reliably made, revenue recognised should not exceed the amount of consideration that would be received if the maximum discounts were taken.</td>
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**Impact**

The proposed standard will affect some US GAAP reporting entities, as it will require incentives to be accounted for similarly to current IFRS standards. The proposed standard will require a company to assess the transaction price including the impact of the incentive programme. If the incentive provides the customer with a material right (for example, a discount on future purchases) that would not have been obtained without entering into the contract, the incentive is a separate performance obligation. The transaction price is allocated to the separate performance obligations and the amount allocated to the option (that is, the future discount) would be deferred and recognised as revenue when the obligation is fulfilled or the right lapses.

If the incentive creates variability in the pricing of the goods or services provided in the contract (as with volume discounts), management will need to determine the
Proposed standard | Current US GAAP | Current IFRS
--- | --- | ---
probability-weighted estimate of possible outcomes to determine the transaction price. Variable consideration is only included in the transaction price if management can reasonably estimate the amount of consideration to be received. Revenue may be recognised sooner than currently allowed if the consideration can be estimated reasonably.

Example 4 – Retailer-issued coupons

**Facts:** A retailer sells a product and provides the customer with a coupon for 60% off the future purchase of a second, identical product. The retailer typically provides customers with 10% discounts on future purchases. The selling price of the product is $10. How much revenue is recognised on the first sale?

**Discussion:** The retailer estimates the probability that the coupons will be redeemed. If the probability of redemption is 100%, the value of the option is $5 ($10 x 50% discount [that is, the incremental value to the customer of the discount considering a 10% discount is typically offered by the retailer] x 100% expected redemption). The entity allocates $3.33 ($10 x (C5 / (C5 + C10)) of the $10 transaction price to the coupon. The retailer recognises revenue of $6.67 when the product is sold, assuming control transfers, and defers the coupon value of $3.33 until the coupon is redeemed or expires unredeemed. If the coupon is redeemed in connection with a future sale, the $3.33 allocated to the coupon is included with the transaction price associated with the subsequent sale.

Example 5 – Manufacturer-issued coupons

**Facts:** A manufacturer sells 1,000 boxes of laundry detergent to a retailer for $10 per box. The sale from the manufacturer to the retailer is final, and control of the product passes to the retailer. There are no return rights, price protection or stock rotation rights. The retailer sells the laundry detergent to consumers for $12 per box. The manufacturer issues coupons for a $1 discount directly to consumers via newspapers. The coupons are presented by the consumer to the retailer on purchase of the detergent. The customer pays $12 if it has no coupon or $11 if it has a coupon. The retailer submits coupons to the manufacturer and is compensated at the face value of the coupons ($1). It is estimated that 400 coupons will be redeemed. How much revenue should the manufacturer and retailer recognise?

**Discussion:** The manufacturer will recognise $9,600 of revenue ($10,000 less estimated coupon redemption of $400) for detergent sold to the retailer. The retailer will recognise revenue of $12 and cost of sales of $10 for each box on sale to the customer. While not specifically addressed by the proposed standard, we believe the additional consideration paid by the manufacturer represents revenue to the retailer, as the fair value of total consideration received is $12. Cost of sales remains at the original amount paid by the retailer to the manufacturer.

Example 6 – Free product rebate

**Facts:** A vendor is running a promotion whereby a customer who purchases three boxes of golf balls at $20 per box in a single transaction receives a mail-in rebate for one free box of golf balls. How is the consideration allocated to the various deliverables in the arrangement?

**Discussion:** The vendor is selling four boxes of golf balls for $60. Each performance obligation (that is, each box) is allocated $15 based on the relative estimated selling price. Assuming the vendor is unable to determine if the mail-in rebate will be used on the date of sale, the transaction price allocated to the undelivered box is deferred until the earlier of redemption or expiration of the rebate.

Example 7 – Slotting fees

**Facts:** A manufacturer sells $8 million in product to a retailer. The manufacturer also makes a $1 million non-refundable up-front payment to the retailer for product placement services. The retailer's promise to display the manufacturer's products includes stocking and favourable placement of the products. The fair value of the product placement service is $875,000 based on similar transactions. How does the manufacturer account for the up-front payment?

**Discussion:** Although the product placement services are not sold separately, under the proposed standard the service is distinct because it has a distinct function and distinct margin. The manufacturer recognises an expense of $875,000 (the estimated stand-alone selling price of the product placement services) when control of the goods transfers to the retailer. The remaining amount of consideration paid for the product placement services of $125,000 is reflected as a reduction of the transaction price. The manufacturer recognises $7,875,000 in revenue when control of the products transfers to the retailer.
Example 8 – Price protection if retailer subsequently lowers price

**Facts:** On 1 January, a retailer sells a product to customer A for C100 and agrees to reimburse customer A for the difference between the purchase price and any lower price offered by the retailer over the next three months. How does the retailer account for the potential refund?

**Discussion:** The consideration expected to be paid to the customer is reflected as a liability at the time of the sale. The transaction price reflects the C100 sales price less the probability-weighted estimate of the consideration expected to be refunded to customer A.

### Loyalty programmes

Retailers often use customer loyalty programmes to build brand loyalty and increase sales volume by providing customers with incentives to buy their products. Each time a customer buys goods or services, or performs another qualifying act, the retailer grants the customer award credits. The customer can redeem the credits for awards such as free or discounted goods or services. Credits that are not ultimately redeemed are forfeited. Forfeitures are often termed ‘breakage’.

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<td>An option to acquire additional goods or services gives rise to a separate performance obligation in the contract if the option provides a material right to the customer that the customer would not receive without entering into that contract. The proposed standard requires management to estimate the transaction price to be allocated to the separate performance obligations. The customer is paying for the future goods or services to be received when customer award credits are issued in conjunction with a current sale. Management recognises revenue for the option when it expires or when these future goods or services are transferred to the customer.</td>
<td>There is divergence in practice in US GAAP in the accounting for loyalty programmes. Two models commonly followed are a multiple-element revenue model and an incremental cost accrual model. Revenue is typically recognised at the time of the initial sale and an accrual is made for the expected costs of satisfying the award credits under the incremental cost model. The incremental cost model is more prevalent in practice. Breakage related to award credits expected to be forfeited is accounted for either proportionally as the awards are redeemed or when the awards expire.</td>
<td>Loyalty programmes are accounted for as multiple-element arrangements. The fair value of award credits is deferred and recognised when the awards are redeemed or expire. Revenue is allocated between the initial good or service sold and the award credits, taking into consideration the fair value of the award credits to the customer. The assessment of fair value includes consideration of discounts available to other buyers absent entering into the initial purchase transaction and expected forfeitures.</td>
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**Impact**
The proposed standard is consistent with the multiple-element model currently required under IFRS and thus it may have more impact on US GAAP reporters. The transaction price is allocated between the product and the loyalty reward performance obligations. The amount allocated to the loyalty rewards is deferred, and revenue is recognised when the rewards expire or are redeemed.

The accounting for breakage under the proposed standard may also impact the timing of revenue recognition. Management must consider the impact of breakage for loyalty rewards in determining the transaction price allocated to the performance obligations in the contract.

Example 9 – Loyalty points

**Facts:** A retailer has a loyalty programme that rewards customers one point per C1 spent. Points are redeemable for C0.10 on future purchases (but not redeemable for cash). A customer purchases C1,000 of product at the normal selling price and earns 1,000 points redeemable for C100 of goods or services in the future. The retailer expects redemption of 950 points (that
is, 5% breakage). The retailer therefore estimates a stand-alone selling price for the incentive of $0.095 per point, based on the likelihood of redemption ($0.10 less 5%). How is the consideration allocated between the points and the product?

**Discussion:** The retailer would allocate the transaction price of $1,000 between the product and points based on the relative stand-alone selling prices of $1,000 for the product and $95 for the loyalty reward as follows:

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<th>Product</th>
<th>C913 (C1,000 x C1,000/C1,095)</th>
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<tr>
<td>Points</td>
<td>C 87 (C1,000 x $95/C1,095)</td>
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The C913 of revenue allocated to the product is recognised upon transfer of control of the product; the C87 allocated to the points is recognised on the earlier of the redemption or expiration of the points.

**Gift cards**

The use of gift certificates and gift cards is common in the retail industry. The gift cards or certificates may be used by customers to obtain products or services in the future up to a specified monetary value.

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| Revenue is recognised on the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. | A liability is recognised for the future obligation of the retailer to honour the gift card when the gift card is sold to the customer. The liability is relieved (and revenue recognised) when the gift card is redeemed. The portion of gift cards not redeemed is referred to as breakage. There are three accounting models that are generally accepted for the recognition of breakage, depending on the features of the programme, legal requirements and the vendor’s ability to reliably estimate breakage:  
  - Proportional model (that is, revenue for breakage is recognised rateably as redemptions occur).  
  - Liability (or expiration) model (that is, de-recognise an unredeemed incentive obligation and record revenue when the right expires).  
  - Remote model (that is, if the vendor can reliably estimate pattern of redemption over time, recognise breakage revenue as the possibility of redemptions become remote). | Payment received in advance of future performance is recognised as revenue only when the future performance to which it relates occurs. That is, revenue from the sale of a gift card or voucher is accounted for when the seller supplies the goods or services on exercise of the gift card.  
No specific models are provided for recognising breakage. The models used under US GAAP are acceptable under IFRS. |

Where escheatment laws apply, the vendor cannot recognise breakage revenue from escheatable funds since it is required to remit the funds to a third party even if the customer never demands performance.
Example 10 – Gift cards

**Facts:** A customer buys a C100 gift card from a retailer, which can be used for up to one year from the date of purchase. The retailer estimates that the customer will redeem C90 of the gift card and C10 will expire unused (10% breakage). Based on all applicable laws (that is, unclaimed property laws), when the gift card expires the entity has no requirement to remit any unused funds to the customer or any third party. The company’s accounting policy for breakage is to apply the proportional model. Deferred revenue of C100 is recorded upon sale of the gift card. How is revenue recognised when the gift card is redeemed?

**Discussion:** For every C1 of gift card redemptions, the retailer recognises C1.11 (C1.00 x C100 / C90) of revenue, with C0.11 of the revenue reflecting breakage. For example, if the customer purchases a C50 product using the gift card, the retailer recognises C55 of revenue, reflecting the product’s selling price and the estimated breakage of C5.

**Licences and royalties**

Licences are common in the retail and consumer sector – both from the licensor and licensee perspective. Many of the products that are sold today include a licensed image or name. The accounting for licences under the proposed standard may be significantly affected.
Impact
The accounting for licences and royalties may be significantly affected under both US GAAP and IFRS. An estimate of royalties to be received is included in the transaction price at the probability-weighted amount if an entity can reasonably estimate the amount expected to be received; it is recognised as revenue when control of the intellectual property is transferred. This may result in revenue being recognised earlier under the proposed standard than under current practice.

Licensors may have to perform a much more in-depth assessment of the legal terms of contracts to determine when control of the associated asset has been transferred.

Licensors will need to focus on whether the asset is being licensed on an exclusive or non-exclusive basis, as well as compare the term of the licence to the underlying asset's economic life to determine whether the transaction is in substance a sale.

Example 11 – Exclusive licenses

Facts: A designer jeans company has a worldwide recognised brand. A global manufacturer of dolls often contracts with the designer jeans company for the rights to use its brand name on the clothes of the dolls. The terms of the agreement provide the doll manufacturer exclusive rights to use the brand name on the clothes of its dolls for a period of two years. During the contractual term, the jeans company will receive 12% of all sales of dolls that include garments branded by the jeans company. The manufacturer will provide updated sales estimates on a quarterly basis and actual sales data on a monthly basis. When does the designer jeans company recognise revenue?

Discussion: The designer jeans company has provided the manufacturer with an exclusive licence. If the term of the licence is for less than the economic life of the underlying brand name, revenue is recognised over the term of the licence. The economic life of the brand name is longer than two years; the transaction is not therefore a sale. Revenue is recognised over the term of the licence agreement. The consideration to be received by the designer jeans company is dependent on the level of sales of dolls, so the transaction price is the probability-weighted estimate of consideration to be received from the manufacturer, presuming the consideration can be reasonably estimated. Assuming the doll maker expects doll sales of C100 million during the term, the transaction price is C12 million.

Warranties
Products are often sold with standard warranties that provide protection to the customer that the product will work as intended for a fixed period of time. Many companies also offer extended warranties that cover defects that arise after the initial warranty period has expired. Standard warranties have historically been accounted for as a cost accrual; extended warranties currently result in the deferral of the revenue. The model for accounting for warranties will be significantly affected by the proposals, as warranties for defects that arise subsequent to the original sale (both standard and extended warranties) will result in the deferral of revenue for the value of the related warranties. Management will need to closely consider the impact that accounting for warranties may have on its operations.

Table: Warranties

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<td>A warranty might provide a customer with coverage for latent defects (that is, those that exist when the asset is transferred to the customer but that are not yet apparent). This warranty does not give rise to a separate performance obligation but acknowledges the possibility that the warranty will be triggered.</td>
<td>Warranties are commonly included with product sales. Such warranties may be governed by third-party regulators depending on the nature of the product. For standard warranties, estimates of warranty claims are accrued at the time of sale for the estimated cost to repair or replace covered products.</td>
<td>In contracts that include a warranty provision, management must determine if the warranty obligation is a separate element in the contract. When a warranty is not a separate element and represents an insignificant part of the transaction, the seller has...</td>
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entity has not satisfied its performance obligation. No revenue is recognised at the time of sale for defective products that will be replaced in their entirety. However, warranties that require replacement or repair of components of an item result in revenue being deferred for only the portion of revenue attributable to the components that will be repaired or replaced.

A warranty might also provide a customer with coverage for faults that arise after the product is transferred to the customer (for example, normal 'wear and tear'). These warranties give rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception. Revenue is recognised over the warranty period.

Extended warranties result in the deferral of revenue for the value of the separately priced extended warranty. The value deferred is amortised to revenue over the extended warranty period.

completed substantially all of the required performance and can recognise the full consideration received as revenue on the sale. The expected future cost to be incurred relating to the warranty is not recorded as a reduction of revenue but as a cost of sale, as the warranty does not represent a return of a portion of the purchaser's sales price. The cost of warranties is determined at the time of the sale; a corresponding provision for warranty costs is recognised. If the cost of providing the warranty service cannot be measured reliably, no revenue is recognised prior to the expiration of the warranty obligation.

The consideration for the sale of extended warranties are deferred and recognised over the period covered by the warranty. In instances where the extended warranty is an integral component of the sale (that is, bundled into a single transaction), management attributes a relative fair value to each component of the bundle.

**Impact**
The proposed accounting for warranties is a significant change for both U.S. GAAP and IFRS, as it will no longer be acceptable for an entity to fully recognise revenue on sale and accrue the expected cost of the warranty. The warranty obligation is treated as a failed sale, for which revenue will be deferred, when the asset must be replaced or repaired.

Management will need to carefully assess whether products are defective at the time control transfers to the customer. If defective products are delivered to the customer, management will need to defer the entire transaction price if the entire product must be replaced, as the entity has not satisfied its performance obligation to provide a good that operates as intended at the time of transfer. A portion of the revenue equal to the standalone selling price of the component is deferred if only the defective component of a product must be replaced.

**Example 12 – Warranties**

**Facts:** A manufacturer sells a radio for C100, which comes with a warranty that ensures the quality of the product during its lifecycle. Historically, the manufacturer has experienced a 5% warranty claim rate. How much revenue is deferred?

**Discussion:** The probability of a product failing to meet its specifications is 5%. The manufacturer defers C5 of revenue each time a product is sold. At each reporting date leading up to the expiration of the warranty, the manufacturer reassesses the probability of the product operating as intended and recognises revenue as the warranty obligation expires.