Statement of Financial Accounting Standards No. 48

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Revenue Recognition When Right of Return Exists

June 1981

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 48 Summary

This Statement specifies how an enterprise should account for sales of its product in which the buyer has a right to return the product. Revenue from those sales transactions shall be recognized at time of sale only if *all* of the conditions specified by the Statement are met. If those conditions are not met, revenue recognition is postponed; if they are met, sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns and expected costs or losses shall be accrued.

INTRODUCTION

1. As discussed in FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters,* the FASB is extracting the specialized [1] accounting and reporting principles and practices from AICPA Statements of Position (SOPs) and Guides on accounting and auditing matters and issuing them in FASB Statements after appropriate due process. This Statement extracts the specialized principles and practices from SOP 75-1, *Revenue Recognition When Right of Return Exists,* and establishes accounting and reporting standards for sales of an enterprise's product in which the buyer has a right to return the product.

2. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraphs 10-12 are advisable in the circumstances.

APPLICABILITY AND SCOPE

3. This Statement specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate customer or by a party who resells the product to others. The product may be returned

for a refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or in exchange for other products. The purchase price or credit may include amounts related to incidental services, such as installation.

4. This Statement does not apply to: (a) accounting for revenue in service industries if part or all of the service revenue may be returned under cancellation privileges granted to the buyer, (b) transactions involving real estate or leases, or (c) sales transactions in which a customer may return defective goods, such as under warranty provisions.

5. This Statement does not modify any of the provisions of FASB Statement No. 49, *Accounting for Product Financing Arrangements.* A product financing arrangement as defined in that Statement should be accounted for as a borrowing rather than as a sale.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Criteria for Recognizing Revenue When Right of Return Exists

6. If an enterprise sells its product but gives the buyer the right to return the product, revenue from the sales transaction shall be recognized at time of sale only if all of the following conditions are met:

a. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
c. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.[2]
e. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
f. The amount of future returns [3] can be reasonably estimated (paragraph 8).

Sales revenue and cost of sales that are not recognized at time of sale because the foregoing conditions are not met shall be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first.

7. If sales revenue is recognized because the conditions of paragraph 6 are met, any costs or losses that may be expected in connection with any returns shall be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies.* Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns.

8. The ability to make a reasonable estimate of the amount of future returns depends on many factors and circumstances that will vary from one case to the next. However, the following factors may impair the ability to make a reasonable estimate:

a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand
b. Relatively long periods in which a particular product may be returned
c. Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers
d. Absence of a large volume of relatively homogeneous transactions

The existence of one or more of the above factors, in light of the significance of other factors, may not be sufficient to prevent making a reasonable estimate; likewise, other factors may preclude a reasonable estimate.

Amendment to Statement 32

9. The reference to SOP 75-1, *Revenue Recognition When Right of Return Exists,* is deleted from Appendix A of Statement 32. The specialized accounting provisions of that SOP are superseded by this Statement.

Effective Date and Transition

10. This Statement shall be effective for fiscal years beginning after June 15, 1981, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on sales, income before extraordinary items, net income, and related per-share amounts for each year restated.

11. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying the Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which the Statement is first applied. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes.*) The effect on sales, income before extraordinary items, net income, and related per-share amounts of applying this Statement in a year in which the cumulative effect is included in determining that year's net income shall be disclosed for that year.

12. Retroactive application of the provisions of paragraph 7 may require estimates of returns

and costs or losses from returns that the enterprise has not previously made; information that may have become available after the year being restated may be considered in making those estimates.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

13. It is the practice in some industries for customers to be given the right to return a product to the seller under certain circumstances. In the case of sales to the ultimate customer, the most usual circumstance is customer dissatisfaction with the product. For sales to customers engaged in the business of reselling the product, the most usual circumstance is that the customer has not been able to resell the product to another party. (Arrangements in which customers buy products for resale with the right to return products often are referred to as *guaranteed sales.*)

14. Sometimes, the returns occur very soon after a sale is made, as in the newspaper and perishable food industries. In other cases, returns occur over a longer period, such as with book publishing and equipment manufacturing. The rate of returns varies considerably from a low rate usually found in the food industry to a high rate often found in the publishing industry.

15. Situations that pose particular problems occur when sales result in significant overstocking by customers acquiring product for resale. In those situations, the recognition of revenue in one period often is followed by substantial returns in a later period.

16. SOP 75-1 was developed to reduce diversity in the accounting for revenue when the right of return exists. The following alternative accounting practices were being used when the SOP was issued: (a) no sale was recognized until the product was unconditionally accepted, (b) a sale was recognized and an allowance for estimated returns was provided, and (c) a sale was recognized without providing an allowance for returns and, instead, sales returns were recognized

when the product was returned. The SOP established criteria that had to be met before sales revenue could be recognized.

17. The Board has not undertaken a comprehensive reconsideration of the accounting issues discussed in SOP 75-1 and has extracted the specialized accounting and reporting principles without significant change. Accordingly, some of the background material and discussion of accounting alternatives have not been carried forward from the SOP. The Board's conceptual framework project on accounting recognition criteria will address revenue recognition issues that may pertain to those addressed in this Statement. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

Appendix B: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

18. An Exposure Draft of a proposed Statement, *Revenue Recognition When Right of Return Exists*, was issued February 9, 1981. The Board received 36 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in this appendix.

19. Some respondents requested that the Statement not apply to enterprises that account for inventory using the retail method of accounting. They recommended that sales returns of retailers be permitted to be recognized when merchandise actually is returned for refund or credit. They said that method is appropriate because accounting for sales returns at time of sale for each product sold is not cost justified, for three reasons. First, they believe that the results of recognizing sales returns when returns are made gives substantially the same results as applying the provisions of the Statement, that is, the Statement would have an insignificant effect on sales, gross margins, and earnings. Second, they state that enterprises using the retail method have not maintained historic data on sales returns. They believe that determining the percentage of sales of one accounting period returned in a later accounting period would be time-consuming and costly, because of the number of transactions to be reviewed. Third, if they were to follow the provisions of the Statement, providing for estimated returns for each product would be complex and costly. Others disagreed with the suggestion of exempting retailers from the Statement.

20. The Board believes that the fundamental issue is materiality. The Board recognizes that the provisions of this Statement may not materially affect the financial position and results of operations of some enterprises that currently account differently than specified by this Statement. Like other FASB Statements, the provisions of this Statement need not be applied to immaterial items. With respect to those enterprises for which this Statement would have a material effect, the Board recognizes that detailed record keeping for returns for each product line might be

costly in some cases; this Statement permits reasonable aggregations and approximations of product returns.

21. Some respondents suggested that exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) should not be treated as sales returns for purposes of this Statement. They noted that retailers do not account for those exchanges as sales returns. The Board adopted that suggestion in footnote 3.

22. Several respondents, particularly in the publishing industry, expressed concern that the wording of the condition in paragraph 6(b) (paragraph 11(b) of the Exposure Draft) changed its meaning from the similar condition in SOP 75-1. The Board has refined the wording to clarify that the condition is met if the buyer pays the seller at time of sale or if the buyer does not pay at time of sale but is obligated to pay at a specified date or dates. If, however, the buyer does not pay at time of sale and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product, then the condition is not met.

23. The transition provisions in the Exposure Draft proposed that either prospective application with cumulative effect of a change in accounting principles or retroactive restatement be permitted. The Notice for Recipients of the Exposure Draft requested respondents to comment on whether the proposed transition is appropriate or whether the transition provisions should be limited to one of the alternatives. Of those respondents who commented on the transition provisions, a substantial majority recommended that one method be specified, but they disagreed on which method. The Board believes that, for recurring revenue recognition issues, comparability is enhanced if enterprises apply accounting standards retroactively by restating the financial statements of previous periods, and the Board has, therefore, adopted that method in this Statement. This Statement, however, calls for enterprises that are unable to restate previous years' financial statements to include the cumulative effect of those years in the earliest year restated.

24. Several individual respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required a reconsideration of the provisions of SOP 75-1. Those suggestions were not adopted because such a reconsideration is beyond the scope of extracting the specialized accounting and reporting principles and practices from the SOP, none of the changes was broadly supported, and the Board believes the suggestions should not be adopted.

25. Several respondents requested guidance regarding specific implementation questions; for example, treatment of partial or limited refunds and balance sheet presentation of accruals for expected returns. SOP 75-1 did not provide specific guidance about those questions and the Board concluded that it should not address those questions at this time.

Footnotes

FAS48, Footnote 1--The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

FAS48, Footnote 2--This condition relates primarily to buyers that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents enterprises from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.

FAS48, Footnote 3--Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for purposes of this Statement.