Changes to revenue recognition for financial institutions

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A. Introduction and background

In May 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issued substantially converged final standards on revenue recognition. These final standards are the culmination of a joint project between the Boards that spanned many years. FASB Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues and replaces almost all pre-existing revenue recognition guidance in U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and SEC Staff Accounting Bulletin Topic 13 (which is also part of legacy GAAP for public entities and generally was followed by private companies).

Implementation of the robust framework provided by ASU 2014-09 will result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. For public business entities (PBEs) and certain not-for-profit entities, implementation was required no later than annual reporting periods beginning after December 15, 2017, and the interim periods therein. However, if an entity is a PBE solely because its financial statements or financial information is included in a filing with the SEC pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer's filing with the SEC), it may choose to adopt the new guidance in accordance with either (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies, which is annual reporting periods beginning after December 15, 2018, and interim periods thereafter.

The FASB has amended the guidance originally included in ASU 2014-09 several times since its issuance. The new guidance primarily is included within the following sections of the FASB's Accounting Standards Codification (ASC):

- Topic 606, "Revenue from Contracts with Customers"
- Subtopic 610-20, "Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets"
- Subtopic 340-40, "Other Assets and Deferred Costs – Contracts with Customers"

For a detailed discussion of the new guidance (as amended), refer to A guide to revenue recognition. Additional information is available in our Revenue Recognition Resource Center.

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint Transition Resource Group (TRG). In addition, the American Institute of Certified Public Accountants (AICPA) has organized several industry-specific task forces, including one focused on depository and lending institutions. The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition audit and accounting guide (the Revenue Recognition AAG). Additional information about the Revenue Recognition AAG can be found on the AICPA's website.

B. Scope

We believe the major implementation challenge for financial institutions is determining which transactions are within the scope of the new guidance. Admittedly, the impact is somewhat limited as transactions covered by the following FASB ASC topics are not in the scope of the new guidance:

- Topic 310 - Receivables
- Topics 320 through 325 - Investments
- Topic 405 - Liabilities
- Topic 460 - Guarantees

- Topic 470 - Debt
- Topic 815 - Derivatives and Hedging
- Topic 825 - Financial Instruments
- Topic 860 - Transfers and Servicing
- Topic 944 - Insurance

Given these scope exceptions, interest income recognition and measurement, the largest source of revenue for many community banks, credit unions and middle-market finance companies, generally will not be impacted by the new guidance. However, other sources of income could be affected. Implementation challenges may arise in part from arrangements that are partially within the scope of the financial instruments guidance referred to previously and partially within the scope of the new guidance. Additionally, certain revenue transactions may relate to a financial instrument that is within one of the aforementioned financial instrument topics, but it may not always be obvious as to whether the financial instrument topic specifically addresses revenue recognition. The intention is that if there is specific guidance in other topics of the ASC that address revenue recognition for a given element of a transaction, those other topics should be applied first, or instead of the new guidance if the arrangement in question is solely within the scope of the other topics.

A discussion of the relevance of the new guidance for various categories of revenue for financial institutions follows. It should be noted that each institution must reach its own conclusions based on its specific facts and circumstances.

B.1. Interest and dividend income and fee income on loans (including credit card fees)

Interest and dividend income on investments as well as interest and fee income from loans are expected to be outside the scope of the new guidance given the applicable guidance in ASC 835, “Interest”; the guidance on receivables in ASC 310; and the guidance on investments within ASC 320 through ASC 325. Particular attention has been given to the impact of the new guidance on credit card fees. At its July 2015 meeting, the TRG discussed whether fees earned by a credit-card-issuing bank from the cardholder are within the scope of the new guidance. TRG members and FASB staff noted that credit card fees are within the scope of ASC 310, and as such, are not within the scope of the new guidance. The applicability of the new guidance to cardholder rewards programs also was discussed, and a conclusion was reached that if the fees are within the scope of ASC 310, the rewards program is not within the scope of the new guidance. It was evident from the discussion that the overall nature of the arrangement needs to be considered, and it would not be appropriate to presume an arrangement labeled as a credit-card-lending arrangement is entirely outside the scope of the new guidance if the nature of the arrangement is not that of a credit-card-lending arrangement. This might be the case, for example, if the issuance of the credit card is an incidental component of an arrangement.

B.2. Service charges on deposit accounts

Deposit-related fees are viewed to be within the scope of the new guidance. While ASC 405 addresses the accounting for deposit liabilities, it does not address revenue recognition for the various types of fees that financial institutions earn in conjunction with deposit accounts. In many cases, however, the application of the new guidance may result in the same recognition and measurement as prior practice given that depository arrangements generally can be cancelled by the customer at any time without compensation, resulting in a contract term that is day-to-day. In response to concerns that institutions might mistakenly believe that significant changes could result from the application of the new guidance and that they may need to engage in significant implementation efforts to apply the guidance to deposit fees, the TRG included helpful application considerations in paragraphs 36 through 54 of TRG Agenda Ref No. 52, *Scoping Considerations for Financial Institutions*.

B.3. Servicing and sub-servicing income

Fees related to servicing arrangements that are within the scope of ASC 860 are not within the scope of the new guidance. This issue also was addressed in paragraphs 12.7.28 through 12.7.32 of the Revenue Recognition AAG with the conclusion reached at the April 2016 TRG meeting that while ASC 860 does not include explicit revenue recognition guidance for servicing fees, it does include guidance within ASC 860-50 for the initial and subsequent recognition and measurement of servicing assets and liabilities. Given that cash flows from servicing fees and the measurement of a servicing asset or liability are inextricably linked, ASC 860 was deemed to provide implicit guidance on the accounting for servicing cash flows. This resulted in the viewpoint that servicing arrangements within the scope of ASC 860 are not within the scope of the new guidance. As discussed in paragraph 12.7.30 of the Revenue Recognition AAG, this exclusion is viewed as encompassing not only the servicing fees associated with such arrangements, but also ancillary fees and income that are considered benefits of servicing and incorporated into the measurement of a servicing asset or liability.

Given that servicing arrangements not within the scope of ASC 860 are likely within the scope of the new guidance, it is important for an institution to evaluate each of its servicing and sub-servicing arrangements to determine the appropriate guidance to follow. Institutions should keep in mind that whether a servicing asset or liability was recorded for a particular arrangement is not relevant. An arrangement can be within the scope of ASC 860 and still result in not recording a servicing asset or liability if servicing income at the reporting date is determined to be adequate compensation.

B.4. Fees and commissions from fiduciary, securities brokerage and other activities

Various fees earned by financial institutions related to assets that the institution does not originate or hold are subject to the new guidance. Examples include asset management fees, broker-dealer commissions and any other revenue sources that are not specifically excluded from the scope of the new guidance.

B.5. Guarantee fees

With the exception of fees for product or service warranties, guarantee fees within the scope of ASC 460 or ASC 815 are excluded from the scope of the new guidance. ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, clarified this scope exclusion for guarantees.

B.6. Insurance and investment contracts

Any contracts within the scope of ASC 944, are excluded from the scope of the new guidance. ASU 2016-20 clarified that the scope exception applies to insurance contracts and other contracts, such as investment contracts, that do not subject an insurance entity to insurance risk.

B.7. Sales of financial assets

Given the scope exclusion in the new guidance for contractual rights or obligations within the scope of ASC 860, which governs transfers of financial assets, we would expect sales and participations in loans, investments and other financial assets to be excluded from the scope of the new guidance as long as the transaction is within the scope of ASC 860. With the issuance of ASU 2017-05, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, transfers of in substance nonfinancial assets are excluded from the scope of ASC 860 and are within the scope of the new guidance. If a financial asset is promised or transferred to a counterparty in a contract along with nonfinancial assets and substantially all of the fair value of the assets is concentrated in nonfinancial assets, the financial assets are deemed to be in substance nonfinancial assets.

C. Sales of foreclosed property

Chapter 12 of the Revenue Recognition AAG contains useful guidance for financial institutions in understanding the ramifications of the new guidance for sales of foreclosed property.

New subtopic ASC 610-20, which was created with the issuance of ASU 2014-09, addresses gain and loss recognition and asset derecognition considerations associated with sales of nonfinancial assets to parties other than customers. “Customer” is defined as “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.” As noted in paragraph 12.7.01 of the Revenue Recognition AAG, ASC 610-20 generally will apply to sales of foreclosed property by a financial institution, given that foreclosed properties typically are not an output of a financial institution’s ordinary activities. (The related loan would be an output of ordinary activities, but the foreclosed property that is sold would not be.) It should be noted however that ASC 610-20 does not apply to sale-leaseback transactions.

The application of the new guidance will be more principles based and will require a higher level of judgment than the prescriptive legacy GAAP for real estate sales in ASC 360-20, “Property, Plant, and Equipment – Real Estate Sales.” To illustrate, when the institution selling the property finances the transaction for the purchaser, profit recognition no longer will be explicitly dependent upon required minimum stated percentages for the buyer’s initial net investment and continuing investment as is the case under ASC 360-20. Instead, judgment likely will need to be exercised in evaluating whether a contract exists and in determining when control of the asset passes to the buyer. A regulated institution may want to consider the views of its regulators when making critical judgments in this regard. ASC 610-20 makes reference to various sections of ASC 606 to determine whether a contract exists, when control of the asset is transferred, and the amount of consideration (transaction price) to be included in the gain or loss calculation. A discussion of each of these concepts follows.

C.1. Contract existence

A contract is defined in ASC 606-10-25-2 as “an agreement between two or more parties that creates enforceable rights and obligations.” For a contract to exist, the following five criteria from ASC 606 must be met:

- Commercial substance exists.
- Approvals have been obtained and a commitment to perform exists on the part of both parties.
- Rights of both parties are identifiable.
- Payment terms are identifiable.
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur).

In the context of a sale of foreclosed property financed by the selling financial institution, judgment could come into play in determining whether (a) the buyer’s initial and continuing investment demonstrates that it is committed to performing its obligations and (b) collectibility of substantially all of the consideration is probable. For example, a high loan-to-value ratio could indicate that the buyer is not committed to purchase the property and also make collectibility less certain. The collectibility aspect of this determination is illustrated through the following example.

Example: Assessing collectibility in a contract to transfer control of a building in exchange for a 5 percent nonrefundable deposit and long-term financing

The following example is *Example 1—Collectibility of the Consideration, Case A—Collectibility Is Not Probable*, from ASC 606-10-55-95 to 55-98:

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.

The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.

The entity concludes that not all of the criteria in paragraph 606-10-25-1 are met. The entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).

b. The customer lacks other income or assets that could be used to repay the loan.

c. The customer's liability under the loan is limited because the loan is nonrecourse.

The entity continues to assess the contract in accordance with paragraph 606-10-25-6 to determine whether the criteria in paragraph 606-10-25-1 are subsequently met or whether the events in paragraph 606-10-25-7 have occurred.

In situations in which one or more of the contract existence criteria is not met at contract inception, the entity should reassess the criteria each reporting period (as necessary) to determine whether all of the criteria subsequently are met. Conversely, once the criteria are met, they only need to be reassessed if there is a significant change in circumstances, such as a significant deterioration in the buyer's ability to pay.

ASC 606-10-25-7 indicates that when these criteria are not met and an entity receives consideration, the consideration should be recorded as a liability and only recognized as revenue when the amounts paid by the customer are nonrefundable and one or more of the following events have occurred:

- The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity.
- The contract has been terminated.
- The entity has (a) transferred control of the goods or services to which the nonrefundable consideration relates and (b) stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services.

C.2. Transaction price

Consideration should be given to ASC 606-10-32-2 through 32-27 in determining the amount of consideration (transaction price) to be included in the gain or loss calculation. The transaction price should reflect the amount to which an entity expects to be entitled in exchange for transferring promised goods or services. Of specific relevance to financial institutions that finance the sale of foreclosed property are the requirements related to significant financing components stated in ASC 606-10-32-15 through 32-20. While typically the transaction price for a sale of property will be the price to which the parties contractually agree, if the financing terms are not consistent with market terms, the transaction price would need to be determined by using a discount rate that is reflective of the credit characteristics of the buyer as well as the collateral and security for the loan.

C.3. Control transfer

ASC 606-10-25-30 requires that consideration be given to indicators of the transfer of control, including but not limited to, the following:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset. (If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.)
- The entity has transferred physical possession of the asset.
- The customer has the significant risks and rewards of ownership of the asset, excluding any risks that give rise to a separate performance obligation.
- The customer has accepted the asset.

ASC 606-10-25-30 also indicates that to determine the point in time at which a buyer obtains control of the asset and the performance obligation is satisfied such that a sale would be recognized and the asset derecognized, consideration should be given to the guidance in ASC 606-10-25-23 through 25-26, which requires consideration be given to any agreement to repurchase the asset, among other factors. As indicated in ASC 606-10-55-68, the buyer would not obtain control of the asset if an entity has an obligation or a right to repurchase it. As mentioned in paragraph 12.7.19 of the Revenue Recognition AAG, among other factors, consideration should be given to whether the borrower from which the property was foreclosed on has any rights to make certain payments and reclaim the property.

D. Conclusion

Given that many transactions associated with financial instruments are scoped out of the new guidance, the financial institution industry is not expected to be impacted by the new guidance to the extent that certain other industries will. However, all institutions will be impacted to varying degrees by the new guidance. It is important therefore for each institution to perform a complete evaluation of its various sources of revenue to determine the applicability of the new guidance and its impact on transactions within its scope.

Even for those transactions within the scope of the new guidance for which the pattern of revenue recognition is not expected to change, entities must keep in mind the new disclosure requirements as they substantially increase the volume of revenue-related information disclosed in the financial statements. In addition to considering the ramifications of the new guidance on their own financial statements, institutions should give consideration to the ramifications of the new guidance on the financial statements of borrowers that are analyzed for credit purposes, given the pervasive impact it could have on those statements.

To discuss the impact of the new guidance on your institution and its financial statements, don't hesitate to contact your RSM representative.

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