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## Financial Reporting Insights

# IMPACT OF REVENUE RECOGNITION GUIDANCE IN ASC 606 ON FINANCIAL INSTITUTIONS

November 2023

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## 1. Introduction and background

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)* to provide a robust framework and comprehensive principles for addressing revenue recognition issues. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of ASC 606 was codified in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

Additionally, the American Institute of Certified Public Accountants (AICPA) has published a comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the guidance in ASC 606. The Revenue Recognition AAG includes a chapter focused on depository and lending institutions. Additional information about the Revenue Recognition AAG can be found on the AICPA's [website](#).

## 2. Scope

We believe the major issue for financial institutions is determining which transactions are within the scope of the new guidance. The following FASB ASC topics are not in the scope of ASC 606:

- 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, recognition and measurement of interest income, which is the largest source of revenue for many community banks, credit unions and middle-market finance companies, generally will not be within the scope of ASC 606. However, other sources of income could be affected. Challenges in applying ASC 606 can 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 ASC 606. 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 addresses revenue recognition for a given element of a transaction, that other guidance should be applied first, or instead of ASC 606 if the arrangement in question is solely within the scope of the other topics.

A discussion of the relevance of ASC 606 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.

### 2.1 Interest and dividend income and fee income (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 ASC 606 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 treatment of credit card fees under ASC 606. Question 1 of the [FASB Revenue Recognition Implementation Q&As](#) notes that fees earned by a credit card issuing bank from the cardholder are within the scope of ASC 310 and, as such, are not within the scope of ASC 606. Furthermore, Question 2 of the [FASB Revenue Recognition Implementation Q&As](#) addressed the applicability of ASC 606 to cardholder rewards programs and noted that if the credit card fees related to the rewards program are within the scope of ASC 310, the rewards program is not within the scope of ASC 606.

## 2.2 Service charges on deposit accounts

Deposit-related fees are viewed to be within the scope of ASC 606. 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. Given that depository arrangements generally can be cancelled by the customer at any time without compensation, this results in a contract term that is generally day-to-day. Therefore, the revenue recognition is relatively straightforward as the service charges would be recognized when the service is performed. The FASB staff included helpful application considerations for deposit-related fees in question 5 of the [FASB Revenue Recognition Implementation Q&As](#).

## 2.3 Servicing and sub-servicing income

Fees related to servicing arrangements that are within the scope of ASC 860 are not within the scope of ASC 606. This issue also was addressed in paragraphs 12.7.28 through 12.7.32 of the Revenue Recognition AAG and question 4 of [FASB Revenue Recognition Implementation Q&As](#) with the conclusion reached 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. As a result, servicing arrangements within the scope of ASC 860 are not within the scope of ASC 606. 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 ASC 606, 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.

## 2.4 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 ASC 606. Examples include asset management fees, broker-dealer commissions and any other revenue sources that are not specifically excluded from the scope of ASC 606.

## 2.5 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 ASC 606.

## 2.6 Insurance and investment contracts

Any contracts within the scope of ASC 944 are excluded from the scope of ASC 606, including insurance contracts and other contracts, such as investment contracts, that do not subject an insurance entity to insurance risk.

## 2.7 Sales of financial assets

Given the scope exclusion in ASC 606 for contractual rights or obligations within the scope of ASC 860, which governs transfers of financial assets, we believe sales of and participations in loans, investments and other financial assets are excluded from the scope of ASC 606 as long as the transaction is within the scope of ASC 860. Transfers of in substance nonfinancial assets (for example, a receivable sold in a contract in which substantially all of the fair value is concentrated in nonfinancial assets, such as real estate and the related operating leases) are excluded from the scope of ASC 860 and are included within the scope of ASC 606. 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.

## 2.8 Interchange fees

Interchange fees are a portion of the credit card transaction that the card issuer (i.e., a financial institution) retains. These fees are typically paid by the merchants with an intention to compensate the issuer for extending credit to cardholders and for providing authorization and settlement services for credit card transactions. We understand there is diversity in practice with respect to the identification of the customer in these arrangements and whether the fees are in scope of ASC 606, but if these services are determined to be transferred to a customer and are part of a card issuer's ordinary activities, ASC 606 would apply.

# 3. Sales of foreclosed property

Chapter 12 of the Revenue Recognition AAG contains useful guidance for financial institutions in understanding the ramifications of ASC 606 for sales of foreclosed property.

Subtopic ASC 610-20 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 generally not be. It should be noted however that ASC 610-20 does not apply to sale-leaseback transactions, which are within the scope of ASC 842-20.

The application of ASC 606 to sales of foreclosed properties requires a high level of judgment. To illustrate, when the institution selling the property finances the transaction for the purchaser, profit recognition is not explicitly dependent upon required minimum stated percentages for the buyer's initial net investment and continuing investment. Instead, judgment needs to be exercised in evaluating whether a contract exists and in determining when control of the foreclosed property transfers to the buyer. A regulated insured depository 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.

### 3.1 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:

- 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.
- Commercial substance exists.
- 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 the buyer’s initial and continuing investment demonstrates that it is committed to performing its obligations and whether 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 purchasing the property (e.g., a very low initial investment, or down payment, was made by the purchaser) and could also make collectibility less certain. The collectibility aspect of this determination is illustrated through the following example.



**Example 3-1: Assessing collectibility in a contract to transfer control of a building in exchange for a 5 percent nonrefundable deposit and long-term financing (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 each of the following is true:

- The entity has no remaining performance obligations and it has received all, or substantially all, of the amounts promised by the customer
- 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

### 3.2 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.

### 3.3 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 customer is presently obligated to pay the entity for the transferred asset
- The customer has legal title to the transferred 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 customer has physical possession of the transferred asset
- The customer has the significant risks and rewards of owning the asset
- 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.

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