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Financial Services Spotlight
FASB Issues New Revenue Standard

In This Issue:

The ASU outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

The Bottom Line

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09[1] by the FASB and as IFRS 15[2] by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.[3]
- The new requirements are the default guidance for any contracts (or parts of a contract) with customers that are not within the scope of other literature (e.g., guidance on leases or financial instruments). As a result, entities that have entered into contracts with customers may need to analyze those contracts or parts thereof in accordance with the ASU. For contracts within the scope of the new standard, management will be required to apply the new guidance in the ASU.
- An entity will need to carefully assess the ASU's impact on all types of variable consideration and performance-based fees in particular, especially when such fees are based on future market performance.
- To meet the new accounting and disclosure requirements, an entity may have to gather information from contracts with customers that currently is not readily available.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.

[2] IFRS 15, *Revenue From Contracts With Customers*.

[3] The SEC has indicated that it plans to review and update the revenue recognition guidance in SEC Staff Accounting Bulletin (SAB) Topic 13, "Revenue Recognition," in light of the ASU. The extent to which the ASU's guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Beyond the Bottom Line

This *Financial Services Spotlight* discusses the framework of the new revenue model and highlights key accounting issues and potential challenges for financial services entities that recognize revenue under U.S. GAAP or IFRSs. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

Background

The goals of the ASU are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs while (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing "a more robust framework for addressing revenue issues"; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The ASU states that the core principle for revenue recognition is that an "entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

The ASU indicates that an entity should perform the following five steps in recognizing revenue:

- "Identify the contract(s) with a customer" (step 1).
- "Identify the performance obligations in the contract" (step 2).
- "Determine the transaction price" (step 3).
- "Allocate the transaction price to the performance obligations in the contract" (step 4).
- "Recognize revenue when (or as) the entity satisfies a performance obligation" (step 5).

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. Entities are also required to provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

Key Accounting Issues — Banking and Securities

Scope Considerations

In accordance with ASC 606-10-15-4(a),[4] if other Codification topics address how to separate and account for the different products and services in a contract with a customer, entities should consult those topics first. Otherwise, in accordance with ASC 606-10-15-4(b), entities should "apply the guidance in [the ASU] to separate and/or initially measure the part (or parts) of the contract."

The ASU includes a scope exception for financial instruments that are within the scope of other Codification topics. Entities should carefully consider their contracts with customers for multiple products and services and assess whether (1) products or services separated in accordance with other Codification topics should be accounted for under the ASU and/or (2) multiple products and services in contracts with customers should be separated under the ASU's guidance on distinct performance obligations and then accounted for under the ASU.

[4] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

When a portion of a contract is outside the scope of the ASU and another part is within its scope, the consideration allocated to the in-scope portions is any amount that remains after the measurement requirements are considered for the portions of the contract that are not in scope. An entity will treat that residual amount of consideration as the transaction price when allocating and recognizing the in-scope portions of the contract.

Identifying the Performance Obligations in the Contract

When a contract or part of a contract is within the scope of ASC 606, an entity must identify the "distinct" performance obligations in such contracts. Under the new revenue model, a performance obligation is distinct if it meets both of the following criteria in ASC 606-10-25-19:

- "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct)."
- "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract)."

An option to acquire additional goods or services under a credit card reward program would represent a separate performance obligation if it gives the customer a material right that it would not have received without entering into the contract.

If an entity concludes that an element of a contract (e.g., a financial instrument contract) meets both criteria, that element will be considered a distinct performance obligation (e.g., advisory services; loan guarantee fees; or, potentially, credit card reward programs, which are discussed further below).

Underwriting Fees

The ASU supersedes the guidance in ASC 940-605, which (1) specifies that underwriting fees should be recognized as revenue when the underwriting cycle is complete and (2) currently allows underwriting fees that are recognized as revenue to be presented on a net basis (reduced for expenses directly associated with the offering). In the absence of these requirements, entities will need to use judgment in determining both (1) the transaction price, including variable consideration, that is to be allocated to one or more performance obligations and (2) whether such performance obligations are satisfied over time or at a point in time. Further, the presentation of revenue on either a gross or net basis would depend on an analysis of the principal-versus-agent considerations in the implementation guidance.

Performance-Based Fees

For information about performance-based fees, see the discussion in the Investment Management section below.

Credit Card Reward Programs

Credit card issuers commonly give customers an option to acquire additional goods or services for free or at a discount (e.g., under a customer reward program). Under the ASU, such an option would represent a separate performance obligation if it gives the customer a material right that it would not have received without entering into the contract. For an option that is deemed a separate performance obligation, an entity would allocate a portion of the transaction price to the option on a relative stand-alone selling price basis and recognize revenue when control of the good or service underlying the option is transferred to the customer (provided that the customer exercises its right to the option) or when the option expires.

To recognize the effects of the expected breakage as revenue, a financial services entity would need to estimate the timing and amount of breakage on the basis of sufficient historical information.

Thinking It Through

Under the ASU, an entity may need to use significant judgment when determining whether the option to acquire the additional goods or services gives the customer a material right that it otherwise would not have received without entering into the contract. An entity should also use judgment when allocating the contract consideration between (1) goods or services initially sold and (2) any option to acquire additional goods or services. Financial services entities generally use a liability accrual expense approach to account for their reward programs under current U.S. GAAP but will need to reassess their accounting policies in accordance with the ASU's requirements.

In certain instances, a customer may not exercise all of its rights under the option (which results in "breakage" on the contract liability). The ASU addresses how to recognize revenue for customers' rights that are not expected to be exercised (e.g., breakage on customer reward points that are forfeited). Specifically, it states that if an entity is expected to be entitled to the amount of expected breakage, the entity would recognize the effects of the expected breakage "in proportion to the pattern of rights exercised by the customer." Otherwise, the expected breakage would be recognized "when the likelihood of the customer exercising its remaining rights becomes remote."

Thinking It Through

To recognize the effects of the expected breakage as revenue, a financial services entity would need to estimate the timing and amount of breakage on the basis of sufficient historical information (subject to the "constraint" discussed below). If the entity does not expect to be entitled to the estimated amount of breakage, it cannot recognize the breakage as revenue until the likelihood of the customer's exercising its remaining rights becomes remote. To determine whether that likelihood is remote, the entity will need to consider the unclaimed property laws of the particular jurisdiction.

Key Accounting Issues — Insurance

Contracts within the scope of ASC 944 are excluded from the scope of the ASU. In addition, the FASB and IASB have been working on a separate convergence project for insurance contracts. Under the FASB's proposed ASU[5] and the IASB's second exposure draft[6] (collectively, the "insurance proposals"), any entity that issued an insurance contract as defined in the insurance proposals or that purchased a reinsurance contract would have applied the proposed insurance accounting model. However, in February 2014, the FASB tentatively decided to generally limit the scope of insurance accounting to insurance entities. The IASB continues to redeliberate its insurance proposal, although the proposal to date has retained its "contract-based" scope.

Certain insurance-related contracts should be accounted for under ASU 2014-09 in a manner similar to how they are accounted for under current U.S. GAAP. For example, under some contracts, a service provider charges its customers a fixed fee in exchange for an agreement to provide services for an uncertain future event. These contracts would continue to be accounted for under revenue recognition guidance in a manner generally consistent with current U.S. GAAP, subject to the scope of the FASB's insurance accounting guidance as determined when the Board completes its insurance project.

[5] FASB Proposed Accounting Standards Update, *Insurance Contracts.*

[6] IASB Exposure Draft ED/2013/7, *Insurance Contracts.*

Thinking It Through

Fixed-fee contracts that may be accounted for under revenue recognition guidance could include (1) capitation and other fixed-fee medical service arrangements in which the customer is not certain to receive a service from the provider unless certain medical events occur, (2) typical fixed-fee prepaid maintenance and repair contracts, and (3) traditional roadside assistance programs. Although these types of fixed-fee contracts expose their vendors to risk related to uncertain events, such contracts often do not involve risk that qualifies as significant insurance risk under current U.S. GAAP, or are not issued by insurance enterprises. As a result, these contracts would not meet the scope requirements of ASC 944 and therefore would be included within the scope of the new revenue standard. Entities should monitor decisions regarding the FASB's and IASB's respective insurance projects for the latest developments.

Key Accounting Issues — Investment Management

The discussion below addresses performance-based fees, up-front fees, and third-party fees associated with investment management contracts. For more information about how investment managers would apply the ASU's revenue recognition guidance, see Deloitte's June 2014 *Investment Management Spotlight*.

Performance-Based Fees

If a contract's variable consideration is highly susceptible to factors outside the entity's influence (including volatility in a market), the consideration could be subject to significant future reversal.

Fee arrangements may include performance-based fees that are calculated on the basis of the performance of the underlying assets being managed. Sometimes the performance of the underlying assets is evaluated against external factors such as a market index, and the fee arrangements may include complexities such as a high watermark or performance hurdles. Performance-based fees include carried interests and incentive fees.

In each reporting period, there may be uncertainty about the amount the entity will ultimately receive in performance-based fees until the fees are finalized or close to being finalized. In addition, performance-based fees paid to an entity may be subject to clawback provisions for underperformance in future periods. These clawback provisions may exist until the underlying assets are liquidated (which could be several years after the payment).

The SEC staff guidance in EITF D-96[7] (codified in ASC 605-20-S99-1) provides two alternatives for recognizing performance-based management fees. Accordingly, an investment manager elects an accounting policy to do either of the following:

- Defer recognizing performance-based fee revenue until the end of the contract ("Method 1").
- Recognize revenue as of an interim date on which it is considered realizable because of termination provisions in the arrangement ("Method 2").

While the ASU does not supersede the guidance in EITF D-96 (see Thinking It Through below), it provides specific requirements for contracts that include variable consideration (including arrangements whose consideration fluctuates depending on changes in the underlying assets managed by an investment manager). Specifically, it indicates that the estimated variable consideration (or a portion thereof) is included in the transaction price (and therefore eligible for recognition) only to the extent that it is probable that the cumulative amount of revenue recognized will not be subject to significant reversal. This concept is commonly referred to as the "constraint." Entities may use judgment in determining whether to include variable consideration in the transaction price; however, the ASU notes that if the variable consideration is highly susceptible to factors outside the entity's influence (including volatility in a market), the consideration could be subject to significant future reversal.

[7] EITF Topic No. D-96, "Accounting for Management Fees Based on a Formula."

Since an entity's performance-based fees may be affected by the future performance of the underlying assets it manages, it is difficult to accurately predict how much of the performance-based revenue payable to the entity is not subject to future reversal until the fees are finalized or close to being finalized. Accordingly, for entities that currently apply Method 2, the timing of revenue recognition for these fees may be significantly delayed by the ASU's constraint on the amount of revenue that may be recognized as of a reporting date.

Thinking It Through

The SEC has indicated that it plans to review and update its revenue recognition guidance in light of the ASU. The extent to which the ASU's guidance will affect a public entity will depend on how the SEC amends the guidance in EITF D-96 to be consistent with the new revenue standard.

Although the ASU could delay the recognition of these fees as revenue, the new guidance does not modify how entities should account for the associated costs (typically, compensation paid to employees). That is, although the revenue may be deferred until long after cash has been received by the entity, amounts distributed to employees may need to be recognized as an expense in the period in which the amounts are incurred since they represent costs associated with fulfilling the contract.

The extent to which the ASU's guidance will affect a public entity will depend on how the SEC amends the guidance in EITF D-96 to be consistent with the new revenue standard.

Thinking It Through

While the ASU includes a scope exception for financial instruments that are within the scope of other ASC topics, it does not address whether contracts involving performance-based fees in the form of carried interests are (1) revenue contracts within the scope of the ASU or (2) financial instruments that should be accounted for as equity-method investments. This issue may be discussed by the AICPA implementation group.

Up-Front Fees

Investment managers may own a broker that distributes sponsored products. For front-end loaded distributions, there is generally an up-front fee (initial sales fee) that investors pay to the broker upon subscription to the fund. Entities would apply the ASU's guidance on up-front fees to determine whether such fees are related to the transfer of a promised service. If the activities that were purportedly related to the up-front fees are determined not to represent a separate performance obligation (i.e., not to result in the transfer of a promised service), revenue recognition would be deferred. This is a change from current practice. Investment managers have noted that the service period for managing a client account is difficult to determine given that the tenure of a client relationship may be indefinite or may be terminated by the client at will.

Third-Party Fees and Contract Costs

Investment managers often incur fees to third parties for distributing the investment managers' products. These fees include sales commissions, marketer fees or trailing commissions, and placement fees. The ASU contains specific guidance on the capitalization of costs related to obtaining and fulfilling a contract. The ASU retains the cost guidance in ASC 946-605-25-8 that permits distributors of mutual funds that do not have a front-end sales fee to defer and amortize incremental direct costs. Other costs incurred to obtain or fulfill a contract with a customer would be accounted for under the ASU's cost guidance.

Key Accounting Issues — Real Estate

Sales of Real Estate

The ASU supersedes the guidance in ASC 360-20 (formerly FAS 66[8]) that currently requires entities to consider certain bright-line criteria in their evaluation of when to recognize, and how to measure, revenue from transactions involving the sale of real estate. Under the ASU, if selling real estate is part of an entity's ordinary activities, the entity would apply the recognition and measurement provisions of the new revenue standard (ASC 606) to its contracts with customers. Even if selling real estate is not part of the entity's ordinary activities (i.e., the entity transfers or sells real estate to a contractual counterparty that does not qualify as a customer under the ASU), the entity would still apply some of the guidance in ASC 606 (specifically, the guidance on the existence of a contract, recognition, and measurement) to account for its sales of real estate. The scope of ASC 360-20 as amended by the ASU has been narrowed to include only real estate sales that are part of sale-leaseback transactions. For further discussion of how the ASU affects real estate sales accounting, see Deloitte's July 2, 2014, *Heads Up*.

Construction Contracts

Entities that satisfy performance obligations under construction contracts will need to carefully evaluate the criteria for transfer of control over time to determine whether they can continue to use a method similar to the percentage-of-completion method in ASC 605-35 to recognize revenue.

Entities currently account for certain arrangements under the long-term construction-type contract guidance in ASC 605-35 (formerly SOP 81-1[9]). Although the ASU supersedes most of ASC 605-35, it retains the guidance on recognizing losses from contracts within the scope of ASC 605-35. Under the ASU, entities would recognize revenue as control of a good or service is transferred to the customer. If the control of goods or services (and therefore satisfaction of the related performance obligation) is transferred over time (as defined in the standard), an entity would be required to measure its progress toward completion in a manner that best depicts the transfer of goods or services to the customer. The ASU provides specific guidance on transfers of control over time and on using and applying an output method or an input method for measuring progress toward completion.

Entities that satisfy performance obligations under construction contracts will need to carefully evaluate the criteria for transfer of control over time to determine whether they can continue to use a method similar to the percentage-of-completion method in ASC 605-35 to recognize revenue. Entities cannot assume that the standard will allow them to retain their current methods for measuring progress toward completion. In addition, entities whose contracts have variable consideration (such as contingent revenue) will need to estimate revenue in accordance with the ASU's guidance on constraining revenue, which could result in accounting that differs from that under ASC 605-35. For further discussion of how the ASU would affect an entity's accounting for real estate construction contracts, see Deloitte's July 2, 2014, *Heads Up* and future industry Spotlights.

Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards. For additional information about the new disclosure requirements, see Deloitte's May 28, 2014, *Heads Up*.

Effective Date and Transition

For public entities, the ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs).

[8] FASB Statement No. 66, *Accounting for Sales of Real Estate*.

[9] AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

The effective date for nonpublic entities is annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018. Nonpublic entities may also elect to apply the ASU as of any of the following:

- The same effective date as that for public entities (annual reporting periods beginning after December 15, 2016, including interim periods).
- Annual periods beginning after December 15, 2016 (excluding interim reporting periods).
- Annual periods beginning after December 15, 2017 (including interim reporting periods).

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU:

- *Full retrospective application* — Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients).
- *Modified retrospective application* — Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application. The following chart illustrates the application of the ASU and legacy GAAP under the modified approach for a public entity with a calendar year-end:

January 1, 2017	2017	2016	2015
Initial Application Year	Current Year	Prior Year 1	Prior Year 2
New contracts	New ASU		
Existing contracts	New ASU + cumulative catch-up	Legacy GAAP	Legacy GAAP
Completed contracts		Legacy GAAP	Legacy GAAP

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU.

Thinking It Through

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and to determine the transition approach that is practical to apply and most beneficial to financial statement users.

Considerations and Challenges for Financial Services Entities

To comply with the ASU's new accounting and disclosure requirements, financial services entities will have to gather and track information that they may not have previously monitored.

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the ASU's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for financial services entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion. As a result, financial services entities may need to assess contracts that commenced several years before the ASU's effective date. In addition, financial services entities will most likely be required to perform dual tracking of revenue balances during the retrospective period given the potential difficulty of retroactively recalculating revenue balances when the ASU becomes effective.

Systems, Processes, and Controls

To comply with the ASU's new accounting and disclosure requirements, financial services entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. For example, financial services entities that enter into long-term contracts may need to adjust the transaction price to reflect the impact of any variable consideration and the time value of money. As a result, such financial services entities may need to modify their current accounting practices, as well as their systems and processes, to track detailed data on contract durations and transaction prices.

Further, to ensure the effectiveness of internal controls over financial reporting, management will need to assess whether additional controls should be implemented. Financial services entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the ASU.

Note that the above are only a few examples of changes financial services entities may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the ASU's requirements to determine whether any other modifications may be necessary.

Income Taxes

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available.

If a change in a tax accounting method is advantageous or expedient (including circumstances in which the book method has historically been used), the taxpayer will most likely be required to obtain approval from the relevant tax authorities to use the method. Similar implications may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs. Additional record keeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

Thinking Ahead

Although the ASU is not effective until annual reporting periods beginning after December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply U.S. GAAP), financial services entities should start carefully examining the ASU and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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