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Technical Line

FASB — final guidance

The new revenue recognition standard — banking

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What you need to know

- Banks will need to apply the new standard to credit card arrangements. As a result, the accounting for interchange fee revenue, rewards programs and some annual fees may change.
- Banks that sell real estate will generally be able to derecognize real estate and recognize profit when control of the property transfers. ASC 360-20's prescriptive guidance to evaluate the buyer's initial and continuing investments or the seller's continuing involvement with the property will be superseded.
- The new standard doesn't apply to many of a bank's revenue streams, including interest income and gains and losses on financial instruments.
- The standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods within those years. Banks that consider themselves private will have to follow the public entity effective date if they meet the FASB's definition of a public business entity.

Overview

Banks may need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including industry-specific guidance (i.e., Accounting Standards Codification (ASC) 942-605) that banks use today.

Building a better working world

How much a bank will be affected will depend on its business activities and the terms of its contracts. Although the full effects of the standard are still being analyzed, a bank's revenue recognition practices for credit card arrangements and sales of other real estate owned (OREO) may be affected. The timing of revenue recognition for various bank fees associated with administering customer deposit accounts (e.g., monthly service charges, ATM fees, wire transfer charges) likely will not be significantly affected. Many of a bank's other revenue streams (e.g., interest income, gains and losses on financial instruments) are outside the scope of the new standard.

This publication provides an overview of the new revenue recognition model and highlights key considerations for banks. It supplements our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), and should be read in conjunction with it.

Banks may want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a depository and lending institutions task force the American Institute of Certified Public Accountants (AICPA) has formed to focus on industry issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's depository and lending institutions task force is one of 16 industry task forces the AICPA has established to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our views.

Summary of the new model

The new guidance outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer.

The principles in the new standard will be applied using the following five steps:

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

A bank will need to exercise judgment when considering the terms of its contract(s) and all of the facts and circumstances, including implied contract terms. A bank also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances. On both an interim and annual basis, a bank will generally have to provide more disclosures than it does today and include qualitative and quantitative information about its contracts with customers, significant judgments made (and changes in those judgments) and contract assets recognized from costs to obtain or fulfill a contract.

The principles underlying each of the model's five steps are discussed in the following sections by applying them to credit card arrangements (from the perspective of the card issuer). Specific considerations for financial asset servicing and sales of OREO are also discussed. For a discussion of services provided by broker-dealers (e.g., underwriting, trade execution and custody services, advisory services), see our Technical Line, *The new revenue recognition standard — brokers and dealers in securities* (SCORE No. BB2803). For a discussion of asset management services, see our Technical Line, *The new revenue recognition standard — asset management* (SCORE No. BB2796).

Transition and effective date

The new standard is effective for public entities[1] for fiscal years beginning after 15 December 2016 and for interim periods therein. Under US GAAP, early adoption is prohibited for public entities.

For nonpublic entities, the new standard is effective for fiscal years beginning after 15 December 2017, and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, such as the amount by which each financial statement line item is affected as a result of applying the new standard.

How we see it

In defining public entities, this standard uses the term "public business entity," which is broader than other definitions of public entities in US GAAP. As a result, banks that consider themselves private entities may have to follow the public entity effective date (1 January 2017 for calendar year-end entities) if they meet the FASB's definition of a public business entity.

Banks that meet the definition of a public business entity also will have to make public entity disclosures that are more extensive than those for nonpublic entities.

We understand that the banking regulators are evaluating whether certain private banks meet the FASB's definition of a public business entity.

Scope

The scope of the new revenue recognition guidance includes all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts that are specifically excluded from the scope:

- Financial instruments and other contractual rights or obligations within the scope of ASC 310, 320, 323, 325, 405, 470, 815, 825 and 860 (e.g., receivables, debt and equity securities, derivatives)[2]

- Guarantees (other than product or service warranties) within the scope of ASC 460[3]
- Insurance contracts within the scope of ASC 944[4]
- Lease contracts within the scope of ASC 840[5]
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange[6]

Because financial instruments are outside the scope of the revenue standard, a bank won't use the new standard to account for its investments in securities, loans and derivatives. Banks also won't use the standard to account for interest and dividend income on financial instruments owned or related to reverse repurchase agreements and securities lending activities.

However, the new standard provides guidance for arrangements partially within the scope of the revenue standard and partially in the scope of other standards. In those instances, an entity will first apply the separation and measurement guidance of other topics, if any. Then it will apply the separation and measurement guidance in the revenue standard to any portion of the contract not accounted for in accordance with another topic. For example, a customer contract that includes a line of credit and a fee for administrative services for customer deposit accounts is partially in the scope of the revenue standard (i.e., the portion related to administrative services) and partially in the scope of other standards (i.e., the accounting for the line of credit and any related borrowings is subject to ASC 310, *Receivables*).

Certain contracts may be partially in the scope of the standard and partially in the scope of other standards.

Some common services provided by banks that could be in the scope of the standard include:

- Administration services for customer deposit accounts (e.g., ATM fees, wire transfer fees, checking account maintenance fees)
- Cash management and payment processing services
- Trust and custody services
- Certain financial asset servicing arrangements
- Credit card interchange

OREO is often sold in a transaction that, under the standard, may not be considered a contract with a customer because the sale of the asset may not be an output of the entity's ordinary activities. However, the standard states that sales of nonfinancial assets, including in-substance nonfinancial assets, should be accounted for using new guidance in ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*, which requires entities to apply certain measurement and recognition concepts of the new revenue standard.

Servicing of financial assets

Certain banks provide specific administrative functions for a financial asset (e.g., residential mortgage loan) or group of financial assets. These services include collecting cash flows from borrowers and remitting them to beneficial interest holders, monitoring delinquencies and executing foreclosures. Certain arrangements may require the use of multiple servicers, including master servicers, primary or sub-servicers or special servicers.

Servicing rights are within the scope of ASC 860, *Transfers and Servicing*, which requires the recognition of a servicing asset or liability when the benefits of servicing obtained from the contract are greater than or less than adequate compensation, as defined, for performing the servicing. The benefits of servicing include the revenues from contractually specified servicing

fees, late charges and other ancillary sources of income to be received for performing servicing. ASC 860 also provides guidance on the subsequent measurement of any servicing asset or liability recognized.

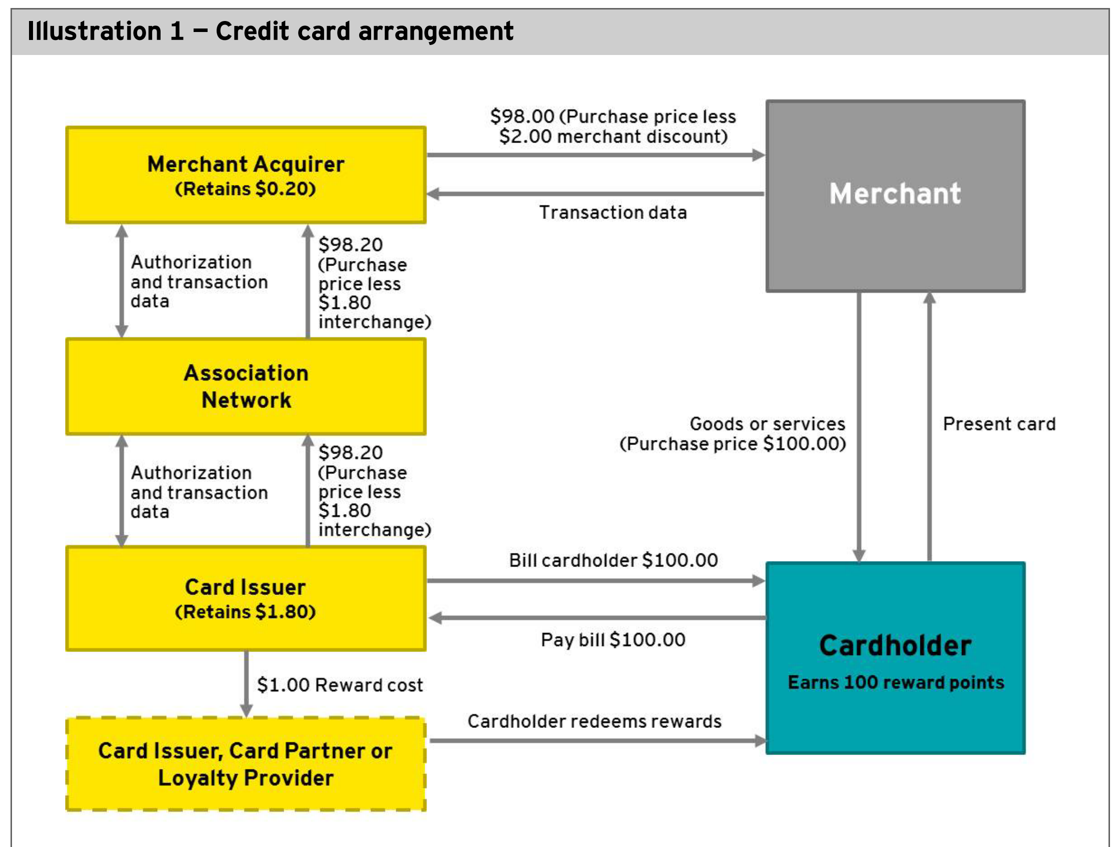
The scope exceptions in the new revenue standard would appear to indicate that contracts that result in the recognition of a servicing asset or liability are not in the scope of the standard. However, because ASC 860 does not provide guidance for recognizing fees associated with fulfilling the obligations under the servicing contract, it may be appropriate for the servicer to apply the new revenue recognition accounting and disclosure requirements to those fees.

Credit card arrangements

A credit card arrangement involves a network of parties that enable a cardholder to purchase goods or services on credit from merchants that accept that type of credit card. There are at least three parties involved: the card issuer (typically a financial institution or bank), the merchant (e.g., a retail store) and the cardholder.

The cardholder enters into a contract with the card issuer (the cardholder contract) that governs the terms and conditions of the use of the credit card by the cardholder. The merchant enters into a separate contract with the merchant acquirer, which may be the card issuer or another entity within the card issuer's credit card network, that governs the terms and conditions under which the merchant will accept the use of a credit card in the sale of the merchant's goods/services (the merchant contract). The arrangement is illustrated below:

Illustration 1 — Credit card arrangement



In a typical credit card arrangement, when a cardholder purchases goods or services from the merchant, the merchant receives an amount of cash that is slightly less than the invoiced price for the goods and services acquired by the cardholder. The card issuer's service of authorizing the credit card transaction and agreeing to transfer funds to the merchant

acquirer or merchant is referred to as interchange. The difference between the invoice price and the cash paid to the merchant is commonly referred to as a merchant discount. The fee collected by the card issuer is referred to as an interchange fee.

Card issuers may administer a credit card rewards program as part of a credit card arrangement. Under these programs, cardholders receive award credits whenever they use their cards to make purchases from merchants. The terms and conditions of a credit card rewards program are included in the cardholder contract, and the characteristics of these programs vary significantly. For example, some credit card issuers give the cardholder the option of redeeming award credits for cash or statement credits, some give the cardholder a choice of goods or services, and some provide award credits in another entity's reward program (e.g., an airline co-branded credit card).

Card issuers can generate cash inflows from interchange fees, fees charged on outstanding credit card balances (i.e., interest charges) and annual fees that entitle a cardholder to use a specific type of credit card.

In May 2013, the Boards discussed requests from financial institutions for additional guidance on credit card rewards transactions. Specifically, financial institutions involved in credit card rewards programs questioned whether the Boards intended a rewards program to be accounted for as a separate performance obligation rather than as a cost of the contract with the merchant.

Interest income from credit card arrangements is outside the scope of the standard.

The Boards confirmed that financial institutions will have to consider the specific facts and circumstances of their credit card rewards programs, given the unique and varied nature of these agreements. The Boards did not further clarify how a credit card company would identify the customer (i.e., whether the customer is the merchant or the cardholder) in arrangements involving rewards programs.

Portions of the following discussion (and the chart above) are based on the May 2013 FASB/IASB Staff Paper, *Application of the model: Credit card reward programs*.[7] The considerations discussed in the following sections contemplate application of the new standard from the card issuer's perspective. This publication does not explore how the application of the standard affects the merchant acquirer's recognition and presentation of revenue associated with the fulfillment of its obligations as part of its participation in the sequence of transactions described above.

Applying the scope of the standard

The accounting for credit card receivables and interest charged on outstanding balances are subject to ASC 310, *Receivables*, so they are not in the scope of the revenue recognition standard.

ASC 310-20 addresses credit card fees, which are defined as "the periodic uniform fees that entitle cardholders to use credit cards." Fee income that meets the definition of credit card fees are viewed as being loan commitment fees and are deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card. In practice, most card issuers currently account for any credit card fees in accordance with ASC 310-20. The new revenue standard did not amend ASC 310-20. Entities will need to exercise judgment to determine whether a portion of the annual credit card fee is partially in the scope of the revenue standard and partially in the scope of ASC 310.

How we see it

Some banks may determine that a portion of the annual credit card fee relates to a rewards program or other services (e.g., airport lounge access, concierge services, car rental insurance) and account for that portion of the annual fee under the revenue model.

Identify the contract(s) with a customer

To apply the model, an entity must first identify the contract(s) and customer(s). Any contracts with a customer that create enforceable rights and obligations fall within the scope of the guidance. Such contracts may be written, oral or implied by the entity's customary business practice but must be enforceable by law. For example, an entity's past business practices may influence its determination of when an arrangement meets the definition of a contract with a customer.

Combining contracts

The standard requires two or more contracts entered into at or near the same time with the same customer (or related parties) to be combined and accounted for as a single contract when any of the following criteria are met: (1) the contracts are negotiated as a package with a single commercial objective, (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contract or (3) the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation (as discussed below).

Identifying the contract in a credit card arrangement

Illustration 1 represents a common structure of a credit card arrangement (i.e., an open loop arrangement where the card issuer generally has no direct contract with the merchant). In contrast, in a closed loop arrangement, a cardholder can only use the credit card to purchase goods or services from a merchant that has a direct contractual relationship with the card issuer (i.e., the card issuer also acts as the merchant acquirer). Regardless of the structure, the following contracts are common to all credit card arrangements:

- Cardholder contract — This contract obligates the card issuer to stand ready to lend/provide financing to the cardholder up to a pre-agreed limit so the cardholder can use the card to acquire goods or services on credit from merchants within the card issuer's network. The cardholder is then obligated to repay the outstanding amount to the card issuer based on the terms and conditions in the cardholder contract.
- Merchant contract (or network agreement) — This contract obligates the card issuer to agree to transfer cash either to the merchant in closed loop arrangements or to an intermediary entity in open loop arrangements when the cardholder uses a credit card to acquire goods or services from the merchant.

How we see it

A card issuer likely will not combine the cardholder and merchant contracts because they are not entered into with the same customer, and the cardholder and merchant generally are not related parties. This conclusion likely applies to both open loop and closed loop arrangements. Even if the card issuer is also the merchant acquirer and the cardholder is a separate and unrelated party from the merchant, the contracts will not be combined.

Identifying the customer in a credit card arrangement

Identifying the card issuer's customer for interchange, which will determine the accounting for any related credit card rewards program, will depend on the specific facts and circumstances of the arrangement.

Credit card arrangements with rewards programs can be complex and terms and conditions can vary significantly. For example:

- The arrangement may be either a closed loop or an open loop arrangement.

- Some credit card issuers charge the cardholder a higher annual fee for participation in a rewards program while other card issuers do not. In addition, some credit card issuers' annual fees give the cardholder rights to other goods or services (e.g., airport lounge access).
- Some credit card issuers actively manage a credit card rewards program (e.g., the card issuer has a catalog of goods or services that the cardholder can choose from), while other card issuers provide a co-branded card product (e.g., an airline miles credit card), which limits redemption to the goods or services of a particular merchant. In other instances, the rewards program allows the cardholder to earn cash awards or statement credits.

The following discusses two views of how a card issuer may identify its customer:

Merchant is the customer

In transactions involving multiple parties, it may be unclear which counterparties are customers of the entity. For some arrangements, multiple parties could all be considered customers of the entity. For simplicity, references to the merchant being the card issuer's customer throughout this publication are meant to include instances when any or all entities in the payment network (i.e., the network association, the merchant acquirer, and the merchant) are considered to be the card issuer's customer.

Some view the merchant as the card issuer's customer for interchange. That's because when a credit card is used by the cardholder, the card issuer provides the merchant with the service of enabling the cardholder to purchase the merchant's goods or services with increased convenience, and it enables merchants to transact with a class of customer that may not have access to sufficient funds at the time of purchase.

In exchange for providing the merchant with a service of greater access to potential customers and the acceleration of cash collection, the card issuer charges an interchange fee. The merchant pays this interchange fee by accepting a reduction in the cash received for the goods or services as full settlement of its customer's purchase (e.g., cash receipt of $98, after a $2 fee is deducted from a $100 sale).

Proponents of this view think that the merchant is the customer for interchange for the following reasons:

- A separate contract exists between the card issuer and either the merchant or an intermediary entity. That contract outlines the terms and conditions (including pricing) of the arrangement.
- The merchant bears the cost of interchange because the merchant will obtain the invoiced price for its goods or services less the interchange fee. If the merchant bears the cost of interchange, proponents of this view think that the merchant must be the party that receives the service related to that cost. Supporters of this view also note that some merchants (e.g., gas stations) try to pass on this cost to the cardholder by charging the cardholder a higher price for using a credit card rather than cash to buy a good or service. Supporters of this view believe that this is evidence that the merchant bears the cost of interchange.

Cardholder is the customer

Some view the cardholder as the card issuer's customer for interchange (and thus the rewards program, if applicable) because the card issuer provides the cardholder two services, a service in the scope of the standard and a service outside the scope of the standard:

- One is a loan to purchase the merchant's goods or services on credit, for which the card issuer may earn interest (a financial instrument transaction not in the scope of the revenue standard).

- The other is the service of electronically transferring funds (obtained from the loan) to the merchant to enable the cardholder to purchase the goods or services. That is, the card issuer is a payment agent acting on behalf of the cardholder. This service is separate from the loan because it is often provided by the card issuer in other cases (e.g., debit cards, charge cards) when the loan portion of the arrangement does not exist.

In exchange for providing the cardholder with the service of electronically transferring funds, the card issuer earns an interchange fee from the cardholder. The cardholder pays for this service by implicitly paying the merchant a higher price for the goods or services than they would otherwise need to pay. Under this view, when a credit card rewards program is in place, the cardholder obtains three different goods or services from the card issuer in the form of credit, interchange and the rewards program.

Proponents of this view think that the cardholder is the customer for interchange for the following reasons:

- In the majority of credit card arrangements, the card issuer has a direct contractual relationship only with the cardholder. Another party in the credit card network association (i.e., the merchant acquirer) has the direct contract with the merchant.
- The cardholder receives the benefits of interchange and pays for it by implicitly paying more for the goods or services from the merchant. Supporters of this view observe that some merchants (e.g., gas stations) charge the cardholder a higher price to use a credit card rather than cash to buy a good or service. However, even if the merchant does not charge a credit card surcharge, supporters of this view believe the merchant takes the cost of the interchange fee into account when determining the selling price of the goods or services on a portfolio basis.

Performance obligations include both explicit and implicit promised goods and services.

How we see it

Identifying the customer (and any related performance obligations) in a credit card arrangement will require significant judgment based on the specific facts and circumstances of the arrangement. Banks should monitor the activities of the TRG and AICPA depository and lending institutions task force for any discussions related to this topic.

Identify the performance obligations in the contract

The standard requires an entity to identify at contract inception all promised goods and services and determine which of these promised goods or services (or bundle of goods and services) represent separate performance obligations. Items represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods or services). A promised good or service that is not distinct is combined with other goods or services until a distinct bundle is formed.

A good or service (or bundle of goods and services) is distinct when both of the following criteria are met:

- 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 (i.e., 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 (i.e., the good or service is distinct within the context of the contract).

Entities will need to consider each contract's specific terms to identify the promised goods and services. The Boards noted that in many cases all of the promised goods or services in a contract might be identified explicitly in the contract. However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices. The standard indicates that when an entity identifies the promises in a contract, it should consider whether the customer has a valid expectation that the entity will provide a good or service.

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer should be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must be considered a performance obligation satisfied over time, and an entity must use the same method to measure the progress of transferring each distinct good or service.

Many services provided by banks (e.g., account administration, trust and custody services) are provided continuously over the contract period, so the service contract will generally represent a single performance obligation with a number of distinct service periods (e.g., days, months, years).

Performance obligations in a credit card arrangement

Interchange likely meets the criteria of a distinct good or service, regardless of who is viewed as the customer. As mentioned above, the stand-ready obligation to provide financing to the cardholder up to a contractual limit is outside the scope of the standard (ASC 310 provides accounting guidance for the credit agreement).

If the cardholder is considered to be the customer and there is a rewards program associated with the credit card, the card issuer will need to determine whether it also has a performance obligation(s) for the rewards program in addition to its performance obligation for interchange.

In making this determination, a bank will need to consider the form of the rewards program. If the award credits are in the form of cash or statement credits, the guidance related to consideration payable to a customer will likely apply (as discussed below), and the rewards will not be considered a separate performance obligation. If the award credits are in the form of goods or services, the delivery of the goods or services related to the rewards program likely will be a separate performance obligation, and the card issuer will need to determine whether it is acting as the principal or the agent in satisfying that performance obligation.

If the merchant is considered to be the customer, the rewards program will not be considered part of the contract with the merchant. The card issuer provides award credits to the cardholder because the cardholder is generating fee income for the card issuer by initiating transactions with the merchant. In this situation, the award credits will be viewed as a cost of the card issuer, similar to a commission paid to a sales agent.

How we see it

Determining whether rewards are a separate performance obligation when the cardholder is viewed as the card issuer's customer may be challenging. The Boards provided example 52 in the standard (ASC 606-10-55-353 to 55-356) that illustrates a customer loyalty program when the rewards points are a separate performance obligation. However, the introduction to the examples section of the revenue standard states that the examples are based on the limited facts presented and do not represent the only way in which the guidance could be applied. It further states that all relevant facts and circumstances need to be evaluated in applying the new revenue guidance.

Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding the amounts collected on behalf of third parties. For contracts in which the promised consideration is variable (e.g., a contract with a performance bonus), an entity will need to estimate the amount of consideration to which it expects to be entitled. The amount of variable consideration to be included in the transaction price (subject to a constraint described below) will be estimated using either an expected value method (e.g., sum of probability-weighted amounts) or a most likely amount method. An entity is required to use the estimation method that best predicts the consideration to which it will be entitled.

When estimating the transaction price, all information (historical, current and forecast) that is reasonably available should be considered, and a reasonable number of possible outcomes should be identified (i.e., an entity is not required to consider all possible outcomes). The method used to estimate the transaction price should be used consistently throughout the contract and for similar types of contracts. An entity will have to update the estimated transaction price at each reporting date.

Constraining estimates of variable consideration

The amount of variable consideration an entity can include in the transaction price is limited to the amount for which it is probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. This determination includes considering both the likelihood and the magnitude of a revenue reversal. Further, the constraint on variable consideration focuses on reversals that would be significant when compared with the cumulative amount of revenue recognized, not just variable consideration. Therefore, when the consideration includes both a fixed amount and a variable amount, the entity should assess the magnitude of a possible revenue reversal of the variable amount relative to the total consideration (i.e., the variable and fixed consideration).

The standard provides factors that could increase the likelihood or the magnitude of a revenue reversal. One of these factors is when the amount of variable consideration is highly susceptible to factors outside the entity's influence (e.g., actions of third parties, volatility in the market). Other factors include when the entity's experience with similar contracts is limited or has little predictive value, and when the contract has a large number and broad range of possible consideration amounts. The presence of these factors does not necessarily mean that variable consideration can't be recognized (hence the Boards' use of the term factors rather than criteria), but entities should carefully evaluate the circumstances in which such factors exist and have robust documentation supporting any conclusions that such amounts should not be constrained.

Significant judgment will be required, and all facts and circumstances will need to be considered, when determining whether it is probable that a significant revenue reversal will not occur.

Consideration payable to a customer

The transaction price may be affected by any payments an entity makes to its customer. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

The new standard requires that consideration payable to a customer be recognized as a reduction to the transaction price (and consequently a reduction in revenue) unless the payment is for a distinct good or service that the customer transfers to the entity (e.g., the card issuer buys services from the customer) and the entity can reasonably estimate the fair value of the good or service.

Determining the transaction price of a credit card arrangement

If the merchant is the customer, the transaction price for the contract is the interchange fee. However, the portion of the annual fee that relates to other services, if any (as discussed in the section on applying the scope of the standard above), may be included in the transaction price of a separate contract with the cardholder.

If the cardholder is the customer, the transaction price includes both the interchange fee as well as the portion of the annual fee that relates to the rewards program or other services, if any. Consideration payable may also impact the transaction price as discussed below.

As previously noted, the interest income from the credit card receivable and the portion of the annual fee that is considered a loan commitment fee are outside the scope of the revenue standard and should not be included in the transaction price.

Cash back rewards may reduce the transaction price because they are consideration payable to a customer if the cardholder is the customer.

Refund liabilities and the constraint on variable consideration

Regardless of who is the customer, a portion of the transaction price could vary in amount and timing for such things as refunds or other similar items. That is, the interchange fee is variable consideration. Under the standard, variable amounts are estimated and included in the transaction price using either the expected value or the most likely amount approach, whichever best predicts the consideration to which the entity is entitled. Banks will include variable consideration in the transaction price only to the extent that it is probable that a significant reversal of the cumulative revenue recognized will not occur. The estimate of variable consideration is updated at the end of each reporting period for changes in circumstances.

The estimate of variable consideration will not include the amount expected to be refunded to the customer (e.g., any amount of the interchange fee the bank expects to refund when a cardholder returns merchandise to the merchant). Therefore, an entity will recognize a contract liability when it receives consideration from the customer that it expects to refund.

Cash back rewards

If the cardholder is the customer, cash back rewards programs and rewards programs that provide statement credits will likely be consideration payable to a customer. However, the standard allows other items to be considered consideration payable to the customer only to the extent that they can be applied to the amount the customer owes to the card issuer. Because most non-cash award credits cannot be applied to the amount the cardholder owes to the card issuer, they will not be consideration payable to the customer for purposes of the revenue standard. Goods and services are not consideration payable to the customer but are generally performance obligations.

When a cash back reward is the only reward option available to the cardholder and the cardholder is determined to be the customer, the transaction price for the contract will be the interchange fee plus the portion of the annual fee that relates to the rewards program or other services, if any, less the cash payable to the cardholder.

How we see it

Many credit card rewards programs provide for cash awards or statement credits as a redemption option. The standard does not address situations when a contract provides the customer with discretion over the type of consideration (e.g., cash or noncash) to be received.

Some credit card issuers also provide promotional offers wherein a credit card holder may be able to earn additional cash back rewards for certain types of purchases within predefined time frames. The consideration payable to the customer in these situations may exceed the transaction price. The standard does not address such situations.

Allocate the transaction price to the performance obligations in the contract

Once the performance obligations have been identified and the transaction price has been determined, an entity will allocate the transaction price to the performance obligations generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). The transaction price is not reallocated to reflect changes in standalone selling prices after contract inception.

Under the standard, the standalone selling price represents the price for which an entity will sell a good or service underlying each separate performance obligation on a standalone basis at contract inception. The model indicates that the observable price of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices are not readily observable. If that's the case, the entity must estimate the amount for which it would sell each performance obligation on a standalone basis.

The standard provides methods for estimating standalone selling price, including an expected cost plus a margin approach, an adjusted market approach and a residual value approach. The residual value approach may be considered in cases when the selling price is highly variable or is uncertain (e.g., the good or service has not been sold on a standalone basis or a selling price has not been established).

The standard provides two exceptions to the relative standalone selling price method to allocate the transaction price. It provides guidance for allocating variable consideration to one or more (but not all) performance obligations and to one or more (but not all) distinct goods or services that form part of a single performance obligation.

A contract's variable consideration is allocated entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if:

- The terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation, and
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the objective to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.

For services performed over time, the variable consideration may be allocated to distinct goods and services instead of being spread over the entire performance obligation if the two criteria are met.

Allocating the transaction price to the performance obligations in a credit card arrangement

If the merchant is the customer, the credit card arrangement has a single performance obligation (i.e., interchange) and the bank will allocate the entire transaction price to that performance obligation.

In contrast, if the cardholder is the customer and a card issuer identifies the satisfaction of the rewards program or other services as separate performance obligations, the card issuer is required to allocate the transaction price (i.e., the interchange fee and a portion of the annual fee, if any) to interchange and those respective performance obligations based on their relative standalone selling prices.

How we see it

The standalone selling prices of rewards may not be readily observable. In these situations, an entity will have to estimate the amount for which it would sell each good or service on a standalone basis. This may be difficult and will require significant judgment.

Recognize revenue when (or as) the entity satisfies a performance obligation

Revenue is recognized only when a performance obligation is satisfied, which is when the promised good or service is transferred to the customer. A good or service is considered to be transferred when the customer obtains control, which is represented by the transfer of rights with regard to the good or service.

An entity must determine whether it transfers control of a promised good or service over time or at a point in time. The standard states that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time.

When a performance obligation is satisfied over time, the standard requires an entity to select a single method to measure progress for each performance obligation that best depicts the entity's performance in transferring control of the goods or services to the customer. That method should be applied consistently to similar performance obligations and in similar circumstances. The standard provides that revenue on arrangements involving the transfer of goods or services over time may be recognized by applying either an input method or an output method. Under an input method, revenue is recognized based on the ratio of efforts already expended relative to the total efforts expected to be expended. Under an output method, revenue is recognized based on direct measurements of the value to the customer of the goods or services transferred to date. These direct measurements include milestones reached and time elapsed.

When an entity applies an output method, the standard provides a practical expedient that allows an entity to recognize revenue in the amount to which the entity has a right to invoice if that consideration corresponds directly with the value to the customer of the entity's performance completed to date (e.g., a services contract in which an entity has the right to bill a fixed amount for each hour of service provided).

Recognizing revenue in a credit card arrangement

Interchange is generally satisfied at a point in time. Regardless of who is the customer, the transaction price allocated to interchange likely will be recognized as revenue when the cardholder purchases the good or service from the merchant. Once the merchant has sold the goods to the cardholder and the merchant is entitled to receive the discounted payment, both the merchant and the cardholder have received the benefits from the transaction.

Other services (e.g., access to an airport lounge, concierge services) will likely be satisfied over time because the card issuer stands ready to provide those services throughout the performance period. The transaction price related to these services will be recognized as revenue over the period the services are provided to the cardholder (e.g., the annual membership period). This may be consistent with the timing of revenue recognition of these fees today.

If the cardholder is identified as the customer, any performance obligation related to the rewards program will likely be satisfied at a point in time. The performance obligation may be satisfied when the cardholder redeems the award credits for a good or service, or it may be satisfied when the cardholder's account with a third party is credited with miles or points. The determination of when the performance obligation is satisfied will require significant judgment and will depend on the specific facts and circumstances of the rewards program.

Principal versus agent considerations

Rewards programs generally enable the cardholder to acquire goods or services using award credits. The goods or services that may be acquired by the cardholder typically are not those produced or provided by the card issuer in the ordinary course of business, so banks typically enter into agreements with vendors of those goods or services to fulfill their performance obligation to the cardholder.

If the cardholder is determined to be the customer and the rewards are redeemed for goods or services, the card issuer will need to determine whether it is acting as a principal or an agent when evaluating its performance obligation under the rewards program. An entity is a principal if it controls a promised good or service before it transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if it obtains legal title only momentarily before the good or service is transferred to a customer.

If the bank determines that its performance obligation is to provide the good or service (i.e., the bank is the principal in the arrangement), the revenue recognized is the gross amount to which the entity expects to be entitled. If the bank is acting as an agent (because its responsibility is to arrange for another party to provide the good or service), the revenue recognized is the net amount to which the entity is entitled to retain in return for its services.

The standard provides the following indicators of when an entity is an agent:

- Another party is primarily responsible for fulfilling the contract.
- The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
- The entity does not have discretion in establishing prices for the other party's goods or services, and therefore, the benefit that the entity can receive from those goods or services is limited.

- The entity's consideration is in the form of a commission.
- The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

No single indicator listed above is determinative of the relationship.

In some arrangements, the card issuer bank agrees to pay vendors for the selected goods or services on behalf of the redeeming cardholder instead of purchasing goods from the vendor prior to the redemption of the rewards. In these cases, the card issuer generally does not have control of or take title to the products, does not have any inventory risk and may not have latitude in pricing. These facts may support an agency relationship.

However, in other arrangements, a bank may purchase a block of goods or services from a vendor. Since the bank obtains control of and takes title to the goods and has inventory risk, the bank is likely to be considered the principal, depending in part on how long the inventory is held. Other arrangements may require more judgment, such as when a bank guarantees that a minimum number of units will be purchased or guarantees that a minimum amount of consideration will be paid to the vendor over the course of the arrangement (i.e., the bank assumes inventory risk). The bank will need to carefully consider whether it has obtained control of the goods and evaluate the indicators to determine whether it is the principal or an agent.

How we see it

If the cardholder is the customer and the card issuer is the principal related to the rewards obligation, the cost of fulfilling the rewards obligation will likely be presented as an expense rather than as a reduction of the revenue allocated to that obligation. This could be a change in practice for some card issuers.

Customers' unexercised rights

The new revenue standard provides guidance on accounting for breakage, which is the portion or percentage of customers eligible to qualify for an offer that ultimately will not earn or claim the offer. For example, in the case of credit card rewards programs, breakage may result from a customer terminating the credit card relationship and not using the outstanding award credits if the cardholder is the customer.

The new standard allows entities to recognize any expected breakage as revenue in proportion to the pattern of rights exercised by the customer because entities will not be required to fully satisfy their performance obligations related to the breakage. Otherwise, breakage amounts will be recognized when the likelihood of the customer exercising its right becomes remote. Because breakage amounts essentially represent a form of variable consideration, an entity will need to consider the constraint on variable consideration in estimating any breakage amount. That is, if it is probable that a significant revenue reversal will occur for any estimated breakage amounts, an entity will not recognize those amounts until the potential for reversal has passed.

How we see it

A bank will need to update its estimate of breakage at each reporting date and may also need to revise the revenue to be recognized on a prospective basis, which will add complexity to a bank's revenue recognition practices. Banks may need to collect and retain new data so they can more closely analyze reward redemption patterns. Modifications to processes and systems may be required.

Contract costs

The standard also provides guidance on accounting for an entity's costs incurred in obtaining and fulfilling a contract to provide goods and services to customers.

Costs to obtain a contract

Under the standard, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. Costs can be recovered directly (i.e., through reimbursement under the contract) or indirectly (i.e., through the profit margin inherent in the contract). As a practical expedient, the standard permits immediate expense recognition for contract acquisition costs if the amortization period of the resulting asset is one year or less.

Capitalized costs are amortized in a systematic manner consistent with the pattern of transfer of the related goods or services and are subject to an impairment analysis.

Costs to fulfill a contract

Entities will continue to follow the guidance on costs incurred in fulfilling a contract with a customer that are within the scope of another ASC topic (e.g., industry-specific guidance).

If no specific guidance is provided in another ASC topic, the standard requires an entity to recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

Costs of a credit card contract

If the cardholder is considered to be the customer, costs incurred to fulfill rewards programs or other services (e.g., airport lounge membership) before the related performance obligations are satisfied will typically meet the capitalization criteria above. Any capitalized contract costs are ultimately expensed as the entity transfers the goods or services to the customer (i.e., when the performance obligation is satisfied).

Sales of real estate

Loans are often collateralized by real estate, such that when a borrower defaults on its loan, the lender may foreclose on the real estate under the terms of the loan agreement. Banks generally record real estate at fair value upon foreclosure. A bank's objective is typically to sell foreclosed assets within a short period of time because of regulatory and capital requirements. After foreclosure, these assets are carried at the lower of carrying amount or fair value less selling costs, so significant gains and losses are uncommon. In some cases, banks may determine it is advantageous to finance a portion of the purchase price paid by the buyer.

ASC 360-20 provides prescriptive guidance for the timing of both profit recognition and the derecognition of real estate and/or integral equipment when a sale has occurred. This guidance requires the deferral of gains when (1) the buyer's initial and continuing investments are not sufficient to demonstrate a commitment to purchase the property or (2) the seller retains a form of prohibited continuing involvement.

Application of the new guidance

The guidance in ASC 606 and ASC 610-20 will replace the prescriptive literature in ASC 360-20 with a principles-based approach that will require companies to make a number of judgments and estimates. Entities will generally recognize the sale of a real estate property that is within the scope of ASC 610-20, along with any associated gain or loss, when control of the property transfers to the buyer.

It is likely that substantially all sales of real estate that previously qualified for full accrual profit recognition under ASC 360-20 will continue to meet the criteria for sale (and associated profit) recognition under the new guidance. In some cases, sales of real estate that did not previously qualify for full accrual profit recognition will meet the criteria for sale recognition under the new guidance.

The new guidance provides that sales of nonfinancial assets (e.g., real estate) will be recognized when control of the asset transfers to the buyer. For sales of existing real estate properties, this will generally occur at a point in time. The standard includes the following indicators that control of a promised asset has been transferred:

- The seller has a present right to payment for the asset.
- The buyer has legal title of the asset.
- The seller has transferred physical possession of the asset.
- The buyer has the significant risks and rewards of ownership of the asset.
- The buyer has accepted the asset.

These criteria, which are less onerous than the criteria in ASC 360-20, will often be satisfied at the closing date of most real estate sale transactions.

However, a seller will still have to evaluate, at contract inception, whether it is probable that it will collect the consideration to which it expects to be entitled. A low initial investment may be considered in that assessment. The Boards also indicated that entities should assess both the customer's intent and ability (i.e., capacity) to pay the amount to which the entity will be entitled. Judgment may be required to determine whether an entity's expectation that it will receive less than the stated transaction price indicates that it is not probable that the entity will collect the contractual amount.

If it is not probable that the entity will collect the consideration to which it expects to be entitled, the arrangement will not be considered a contract under the new guidance until the concerns about collectibility are resolved. If the entity subsequently determines that the transaction price is collectible, the arrangement will be recognized under the new guidance at that point in time.

How we see it

ASC 360-20-55-1 to 55-2 provides specific guidance on the minimum initial investment required for an entity to recognize the full profit on a sale (i.e., the full accrual method). This guidance was retained to evaluate sales-leaseback transactions but will no longer be referenced when evaluating real estate sales under ASC 610-20.

Banking regulators have not published their views on the new real estate sales guidance.

Refer to our separate Technical Line, *The new revenue recognition standard — real estate* (SCORE No. BB2811), for a more comprehensive summary of considerations related to real estate.

Next steps

Banks should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition.

All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.

Entities should monitor the discussions of the Boards, the Securities and Exchange Commission (SEC), the TRG and the AICPA's depository and lending institutions revenue recognition industry task force. Banks should also monitor any guidance or interpretations provided by the federal banking regulators.

Public entities also should consider how they communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SAB Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

[1] The standard defines a public entity as one of the following: (1) a public business entity, (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements with the SEC. ASU 2013-12, *Definition of a Public Business Entity,* provides guidance on when a business entity is a public business entity.

[2] ASC 310, *Receivables*; ASC 320, *Investments — Debt and Equity Securities*; ASC 323, *Investments — Equity Method and Joint Ventures*; ASC 325, *Investments — Other*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*

[3] ASC 460, *Guarantees*

[4] ASC 944, *Financial Instruments — Insurance*

[5] ASC 840, *Leases*

[6] ASC 845, *Nonmonetary Transactions*

[7] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2013/May/07A-Revenue%20Recognition.pdf

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