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Contents

FASB Revenue TRG Discusses Implementation Issues

The FASB's Transition Resource Group for Revenue Recognition (TRG) met on April 18, 2016, to discuss implementation issues related to the FASB's revenue topic.[1]

Key Facts

- Contract assets that exist at the time of a contract modification that is treated as a termination of the existing contract and the creation of a new contract, are not written off; instead they are included in the transaction price of the new contract and derecognized prospectively.
- An entity should not recognize a work-in-process asset for performance obligations satisfied over time, because control transfers to the customer continuously as the entity performs.
- Offers for discounted goods or services that accumulate from prior purchases typically provide the customer with a right. However, judgment may be required to determine whether a right is provided when other customers who have not made prior purchases also receive discount offers, and to determine whether a right is material.
- Loan servicing fees and financial guarantee fees earned by financial institutions are not within the scope of the new revenue topic, while deposit-related fees are within the scope (although in some arrangements, the amount allocated to those fees could be zero).
- Many believe that incentive-based capital allocations in the form of a carried interest are compensation earned by investment managers and should be recognized as revenue under the new revenue topic. The FASB may consider whether a technical correction to clarify this scoping question is needed.

Key Impact

- The conclusions of the TRG meeting could have a significant impact on the accounting policies of entities in a number of industries, including airlines, leisure companies, telecommunications, financial services, and investment managers.

[1] The Transition Resource Group's staff papers, and FASB ASC Topic 606, Revenue from Contracts with Customers, are available at www.fasb.org.

Contract Assets That Exist When a Contract Is Modified

The guidance on accounting for contract modifications requires some modifications to be accounted for prospectively, as a termination of the existing contract and the creation of a new contract. The guidance is silent on the treatment of a contract asset that exists when a modification takes place.

TRG Conclusion – Contract Assets That Exist When a Contract Is Modified and the Modification Is Accounted for Prospectively

The TRG members generally agreed with the FASB staff that the existing contract asset should not be written off against revenue at the date of the modification. Rather, the asset should be derecognized prospectively as a reduction of the revenue recognized under the new contract. An entity should consider the effect of the potential modifications on the contract term, material rights, and variable consideration when accounting for the original contract.

Evaluating How Control Transfers Over Time and Accounting for Related Costs

Revenue is recognized under the new topic when or as control over goods and services promised in a contract transfers to the customer. When control transfers over time, revenue is recognized based on the entity's progress toward the complete satisfaction of the performance obligation. Output measures, such as milestones, may be appropriate for measuring progress. However, the topic also states that an output method would not provide a faithful depiction of the entity's performance if that method failed to measure some of the goods or services already transferred (e.g., when the entity has accumulated a significant amount of work-in-process between milestones).

Consequently, some stakeholders questioned whether using milestones as an output measure of progress would be appropriate. Specifically, they asked whether control can transfer at discrete points in time when a performance obligation is satisfied over time and, if so, whether the entity would recognize the work-in-process created between the milestones as an asset.

TRG Conclusion – Evaluating How Control Transfers Over Time and Accounting for the Related Costs

The TRG members agreed with the FASB staff that if control transfers over time, milestones normally would not be an appropriate measure of progress, because control generally transfers continuously as the entity's performance takes place rather than at discrete points in time. Therefore, a milestone

method would need to incorporate a measure of progress between milestone achievements.

The TRG members and FASB staff also made a distinction between work-in-process for an over-time performance obligation and inventory that is purchased or constructed that has an alternative use before it is dedicated to a specific contract.

Work-in-process for an over-time performance obligation would be expensed as a fulfillment cost because control of the work-in-process transfers to the customer as it is produced. However, inventory to support multiple contracts that has an alternative use would be recognized as an asset until it is dedicated to a specific contract.

Considering Class of Customer and Material Rights

The revenue topic specifies that a material right exists if a customer receives a discount that is incremental to the range of discounts typically given for those goods and services, to that class of customer, and in that geographical area or market. That is, the right would not have been obtained without the contract. A material right is different from a broad-based marketing offer because the customer has paid in advance for the right to receive a future discount. A material right is accounted for as a separate performance obligation. A portion of the transaction price of the contract is allocated to the material right, and is deferred until the right is exercised or expires.

TRG Conclusion – Class of Customer and Material Rights

TRG members generally agreed that when a right to a free or discounted good or service accumulates as a result of prior purchases, a material right likely is provided to the customer. Also, a right that accumulates is not necessarily material if the right is insignificant on either an absolute basis or in proportion to the customer's required activity to accumulate the right. For example, a right to obtain a free good could be assessed as material if the customer needs to buy only 2 goods to receive the free good, but assessed as not material if the customer must buy 100 goods to receive the free good.

Some TRG members suggested that evaluating rights that accumulate from prior purchases requires more judgment in more complex scenarios. There could be judgment involved in determining whether a customer's prior purchasing history evidences an accumulating right or instead evidences a method that the entity should use to identify the class of customer to which a customer belongs.

However, most TRG members stated that, when evaluating whether a discount offered to a customer as a result of prior purchases provides the customer with a material right, it would *not* be appropriate to compare the discount offered to that customer with discounts offered to other customers

with a similar purchase history. The class of customer is *not* determined by the customer's prior purchasing history.

Instead, the class of customer *is determined* by other factors such as whether the customer is a retail customer or a large corporate customer. The entity should compare the discount offered to the retail customer who has historically purchased a large amount or value of goods or services from the entity with discounts offered to similar customers that do not have a similar purchase history. Previous TRG discussions concluded that a discount granted in conjunction with a current purchase that could be used only on a future purchase (e.g., 25 percent discount off the customer's *next* purchase of at least $100) provides the customer with a material right.

Because significant judgment may be needed in more complex arrangements and based on input from TRG members, the Board instructed the FASB staff to perform additional outreach with industries that might be significantly impacted, such as the travel and leisure industries.

Example: Determining Whether A Material Right Exists

The following example illustrates the analysis that could be useful in determining whether a material right exists in a contract with a customer.

Tier Status

Airline Company offers a status program. Each customer who has flown more than 50 flights in year 1 is entitled to a free upgrade to business class (subject to availability) on all subsequent flights taken in years 1 and 2, free lounge access, and waiver of baggage fees during that period.

Is the option to obtain free business class upgrades, free lounge access, and free baggage on flights purchased subsequent to when status is achieved a material right?

Appropriate Comparison. Benefits offered to a customer who is a similar frequent flyer (including a customer with another airline who has a comparable status) who has not achieved the 50 required flights with Airline and is therefore not a status customer of Airline.

Not Appropriate Comparison. Benefits offered to a customer that has achieved the same frequent flyer status with Airline.

Conclusion. A material right exists if another frequent flyer without pre-existing status with Airline does not receive the free benefits outlined when flying with Airline. Airline may need to consider its practice of offering status (or equivalent benefits) to new customers that have not achieved the flight requirements. For example, these considerations would include the frequency with which it grants status, whether the customer pays (directly or indirectly) for the status, and whether it receives the same benefits for a similar period of time as the frequent flyer with earned status.

TRG members generally agreed with the FASB staff that the conclusions reached for servicing fees also apply to servicing assets on other types of loans (e.g., auto loans).

Scoping Considerations for Financial Institutions

The TRG members discussed whether three types of fees that financial institutions earn are within the scope of the revenue topic, which excludes contracts with customers that are within the scope of other Accounting Standards Codification (ASC) Topics. For contracts that are partially within the scope of the revenue topic and partially within the scope of another topic, an entity is required to apply the separation and measurement guidance from the other topic if that other topic specifies how to do so. Otherwise, the entity is required to apply the guidance in the revenue topic. The table below summarizes the TRG members' conclusions.

Type of Fees Earned by Financial Institutions	TRG Conclusion
Servicing and sub-servicing fees	Outside the scope of revenue topic if within the scope of ASC Topic 860, *Transfers and Servicing*
Deposit-related fees	Within the scope of revenue topic
Fees from financial guarantees	Outside the scope of revenue topic if within the scope of ASC Topic 460, *Guarantees*, or ASC Topic 815, *Derivatives and Hedging*

Incentive-Based Capital Allocations

Investment managers are compensated in different ways for providing asset management services including a base management fee, an incentive-based fee, or an incentive-based capital allocation in the form of a carried interest in a partnership or similar structure. Incentives are earned based on the performance of the assets under management. Under current U.S. GAAP, investment managers can elect to account for incentive-based fees (including capital allocations) under either of two methods:[2]

- ***Method 1.*** Recognize revenue at the end of the measurement period when all uncertainties are resolved; or
- ***Method 2.*** Recognize revenue in the amount that would be due under the formula as if the contract were terminated at the financial statement date.

The TRG members discussed whether compensation received through a capital allocation should be considered revenue from a contract with a customer under the revenue topic, or as an equity instrument subject to other GAAP.

[2] FASB ASC 605-20-S99-1, Revenue Recognition—Services—SEC Materials—Accounting for Management Fees Based on a Formula, available at www.fasb.org.

TRG Conclusion – Incentive-Based Capital Allocations

Current U.S. GAAP views incentive-based capital allocations in the form of a carried interest as compensation for investment management services. Feedback from recent industry outreach confirmed that asset managers agree with this view. However, some TRG members said that if the SEC withdraws ASC 605-20-S99-1 (EITF Topic No. D-96), there could be a question about whether an in-form equity fee is in the scope of the revenue topic. The Board confirmed that it intended that these arrangements would fall under Topic 606's scope, regardless of the form of consideration. The Board will consider whether a technical correction is needed for clarification.

KPMG Observations

The SEC observer to the TRG indicated that, absent a technical correction, he anticipated that the SEC staff would not object to accounting for a carried interest that is in-form equity under the revenue topic. However, there was a basis for an alternative view that these arrangements are outside of the revenue topic's scope. Several TRG and Board members observed that accounting for asset management arrangements in the form of a carried interest based on other U.S. GAAP would not necessarily result in revenue classification or a "Method 2" measurement and recognition for a carried interest.

Next Steps

The FASB completed its redeliberations on the substantive amendments to the revenue topic, and recently issued two ASUs on principal versus agent considerations and identifying performance obligations and licenses.[3]

In the second quarter we expect the FASB to issue an ASU providing narrow-scope improvements and practical expedients to the revenue topic, and an exposure draft proposing technical corrections to the new revenue topic.[4]

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[3] KPMG's Defining Issues No. 16-10, FASB Finalizes Amendments to Principal-Agent Guidance in New Revenue Standard, March 2016; and No. 16-13, FASB Amends Performance Obligations and Licensing Guidance in Revenue Standard, April 2016. Also see FASB Accounting Standards Update No. 2016-10, Identifying Performance Obligations and Licensing; and Accounting Standards Update No. 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net).

[4] KPMG's Defining Issues No. 16-5, FASB Reaffirms Amendments to Revenue Standard; Discusses Potential Disclosure Relief, February 2016.