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What you need to know

• In conjunction with the new revenue standard, the FASB issued several consequential amendments to other parts of the Accounting Standards Codification that address the accounting for items not historically thought of as revenue.

• Affected items include the sale of certain nonfinancial assets (e.g., real estate) and advertising costs.

• Entities should carefully review these amendments to understand whether they need to change their current practices.

Overview

In conjunction with the release of the new revenue recognition standard, the Financial Accounting Standards Board (FASB) issued consequential amendments to other parts of the Accounting Standards Codification (ASC or Codification).

These amendments are generally consistent with the deliberations by the FASB. However, the amendments may require entities to change how they account for some items not historically addressed in the revenue literature. This may come as a surprise to some companies.

This publication is intended as a companion piece to our Technical Line, A closer look at the new revenue recognition standard. We also plan to publish industry-specific Technical Lines in the coming weeks.
Key considerations

Sale of nonfinancial assets

Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, modifies the Codification to require entities to use the ASU’s recognition and measurement guidance to account for any gain or loss resulting from the sale of nonfinancial assets that are not an output of an entity’s ordinary activities. This includes the sale of intangible assets and property, plant and equipment, including real estate. The ASU also requires the revised guidance to be applied to the transfer of a subsidiary (or a group of assets) that is, in substance, a nonfinancial asset. However, the transfer of a subsidiary (or a group of assets) that is a business but not an in-substance nonfinancial asset will continue to be accounted for in accordance with today’s derecognition guidance.\(^1\)

Under the revised guidance, an entity must first determine whether it has a contract as defined in ASC 606-10-25-1. An arrangement is a contract if all of the following criteria are met:

- The parties to the contract have approved the contract and are committed to perform their respective obligations.
- The entity can identify each party’s rights regarding the nonfinancial asset(s) to be transferred.
- The entity can identify the payment terms.
- The contract has commercial substance.
- It is probable that the entity will collect the consideration to which it will be entitled in exchange for the nonfinancial asset(s) transferred.

How we see it

Entities may find applying the collectibility criterion challenging. Significant judgment will be required to determine whether a partial payment (1) results from a contract with an implied price concession, (2) results from an impairment loss or (3) indicates that the arrangement lacks sufficient substance to be considered a contract within the scope of the guidance.

If the criteria above are met, an entity would look to the control model in the ASU to determine when to derecognize the nonfinancial asset and would measure the amount of the gain or loss to recognize using the ASU’s guidance. However, if the criteria are not met, any consideration received from the other party to the transaction must be treated as a liability on the balance sheet until the arrangement meets the criteria. Further, until those criteria are met, the entity would continue to report the nonfinancial asset (or the in-substance nonfinancial asset) on its balance sheet, amortize those assets with a finite life, and apply the impairment guidance to the nonfinancial assets. Ultimately, if the criteria are never satisfied, the entity can derecognize the asset transferred and recognize the corresponding sale of the asset only when either of the following conditions is met:

- The entity has no remaining obligations to transfer the assets and all, or substantially all, of the consideration promised by the customer has been received.
- The contract has been terminated, and the consideration received from the customer is nonrefundable.
How we see it

The new guidance differs significantly from today’s prescriptive requirements for gain or loss recognition on real estate sales. For example, under today’s guidance, a sale or transfer of real estate and any profit on such a sale or transfer is recognized only if the buyer meets certain initial and continuing investment conditions and the seller doesn’t have certain forms of continuing involvement in the real estate (i.e., a sale is based on the transfer of the risks and rewards of ownership). Under the new model, assuming control of the asset has been transferred, a gain may be recognized for a transaction that does not meet the requirements of today’s real estate sales guidance if the expected transaction consideration is reasonably estimable and exceeds the carrying amount of the real estate sold.

Advertising costs, including ‘direct-response’ advertising

Under today’s guidance, advertising costs are expensed in the period they are incurred or the first time the advertisement appears, except for certain “direct-response” advertising costs, which are reported as an asset and amortized over the future benefit period, if certain conditions are met.3

ASU 2014-09 supersedes the guidance on all advertising costs, including “direct-response” advertising costs, and makes it consistent with the guidance in the new revenue standard for the treatment of costs of obtaining a contract.4 That is, only the incremental costs of obtaining a contract (i.e., costs such as sales commissions that would not have been incurred if the contract had not been obtained) are to be capitalized, and all other amounts are expensed as incurred. The FASB allowed one exception to this for an insurance entity’s direct-response advertising costs, and this aspect of the existing guidance was not superseded. This guidance likely will result in a significant change in practice for some companies, including those in the retail and consumer products, media and entertainment, and technology industries.

Advertising barter

Companies that enter into arrangements to exchange rights to place advertisements on one another’s websites often exchange no cash or exchange similar amounts of cash. Under today’s guidance,5 revenue and expenses from these barter transactions are recognized at fair value only if the fair value of the advertising is determinable based on a company’s historical practice of receiving cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. If the fair value is not determinable, the barter transaction is recorded based on the carrying amount of the advertising surrendered, which is typically zero. This guidance was developed to address concerns that entities were allegedly “round-tripping” online advertising transactions with one another and increasing their advertising revenues for transactions that lacked substance.

ASU 2014-09 supersedes this guidance and does not specifically address these types of transactions. However, the new revenue standard requires that an arrangement have commercial substance to be considered a revenue arrangement with a customer. Further, commercial substance is defined as “the risk, timing or amount of the entity’s future cash flows is expected to change as result of the contract.” Therefore, while the new guidance eliminates today’s abuse-prevention language, it retains the principle that arrangements lacking commercial substance, as defined in the standard (e.g., round-tripping arrangements), should not be accounted for as revenue arrangements. Entities will likely have to use more judgment to determine whether exchanges of services qualify as revenue arrangements under the new guidance.
Share-based payments
The new standard will cause a vendor and a customer to estimate fair value differently for share-based payments made in exchange for goods and services. Today, the guidance a vendor applies to determine fair value is aligned with the guidance the customer applies, generally resulting in both parties valuing share-based payments on the same date and at the same amount.

The new revenue standard replaces the existing guidance in the Codification with general principles covering nonmonetary transactions that likely will result in a change in practice. Under the new guidance, a seller or vendor that receives or expects to receive noncash consideration (e.g., share-based payments) must include the fair value of the noncash consideration in the transaction price. That fair value would be measured according to ASC 820 unless an entity cannot reasonably estimate the fair value of the noncash consideration. In those circumstances, an entity would measure the noncash consideration indirectly by reference to the estimated standalone selling price of the promised goods or services. The vendor’s accounting for share-based payments issued to customers (e.g., for volume discounts) would be unchanged because it is outside the scope of the standard.

Recognition of sales to the dealer when financed
Many equipment manufacturers sell their products (e.g., cars, boats, agricultural or construction equipment) to dealers or distributors and also provide financing to the end customer who purchases the equipment from the dealer or distributor. Today, the equipment manufacturer can recognize the sale upon transfer of risks and rewards to the dealer if certain criteria are met. ASU 2014-09 supersedes this guidance.

Under the new guidance, entities will be required to determine whether a sale to a dealer results in the transfer of control, even though the entity may lease or finance the sale of the equipment to the end customer. Recognizing revenue upon a transfer of control is a different approach from the “risks and rewards” model in current US GAAP. The new guidance states that “control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.” Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service. Entities will need to evaluate these arrangements to determine whether their accounting will change.

Recognition of sales with residual value guarantees
An entity that sells equipment may guarantee that the customer will receive a minimum resale amount when the customer resells the equipment. Today’s guidance precludes the entity from recognizing a sale on the equipment if it guarantees the resale value and instead requires the arrangement to be accounted for as a lease. The new standard does not change that.

However, under the new standard, an entity may be able to conclude that sale treatment is appropriate if the repurchase agreements guidance in the new standard applies. For example, if the residual value guarantee is accomplished by executing a put within the contract (e.g., the customer has the right to require the entity to repurchase equipment two years after the date of purchase at 85% of the original purchase price), the entity would have to use the new revenue standard to determine whether the put precludes the customer from obtaining control of the acquired item. In doing so, the entity would determine whether the customer has a significant economic incentive to exercise the put. If the entity concludes that there is no significant economic incentive, the transaction would be accounted for as a sale in accordance with the new standard. Alternatively, if the entity concludes there is a significant economic incentive for the customer to exercise its right, the transaction would be accounted for as a lease as discussed above.
If the transaction includes a residual value guarantee in which the entity will make the customer whole if the customer receives less than 85% of the initial sale price in a qualifying future sale, it is not clear whether the repurchase agreement guidance in the new revenue standard would apply. That is, because the entity is not repurchasing the asset, that guidance may not apply. Instead, the transaction may be viewed as including a component of variable consideration. While the economics of a repurchase agreement and a residual value guarantee may be similar, the accounting outcome could be quite different.

Endnotes:

1. ASC 810, Consolidation
2. ASC 360-20, Property, Plant, and Equipment – Real Estate Sales
3. ASC 340-20, Other Assets and Deferred Costs – Capitalized Advertising Costs, and Subtopic 720-35, Other Expenses – Advertising Costs
4. ASC 340-40, Other Assets and Deferred Costs – Contracts with Customers
5. ASC 605-20, Revenue Recognition – Services (formerly Emerging Issues Task Force (EITF) 99-17, Accounting for Advertising Barter Transactions)
6. ASC 820, Fair Value Measurement
7. ASC 605-15, Revenue Recognition – Products (formerly EITF 95-4, Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease)
8. ASC 840, Leases, specifically ASC 840-10-55-12, Sales of Equipment with Guaranteed Minimum Resale Amount