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STAFF PAPER

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Project	**Revenue Recognition**		
Paper topic	Effect of the revenue recognition model on asset managers		
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Purpose

1. This paper considers possible refinements to the 2011 Exposure Draft *Revenue from Contracts with Customers* ('2011 ED') to address concerns raised by some respondents about how the proposals would apply to the asset management industry. Specifically, this paper considers how (a) the constraint on revenue recognized and (b) contract cost proposals in the 2011 ED would affect the asset management industry.

Staff recommendation

2. The staff recommend that the Boards:

   (a) retain the constraint proposal in the 2011 ED for recognizing revenue from an asset manager's performance fees; and

   (b) make no changes to the contract cost proposals in the 2011 ED.

3. The staff also recommend that the FASB retain the cost guidance in Topic 946 on financial services – investment companies.

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Structure of the paper

4. The remainder of this paper is organized into the following sections:

   (a) Accounting for performance fees (paragraphs 5 – 30)

      (i) Proposed requirements in the 2011 ED (paragraphs 13 – 15)

      (ii) Summary of respondent feedback (paragraphs 16 – 20)

      (iii) Staff analysis (paragraphs 21 – 28)

      (iv) Staff recommendation (paragraphs 29 – 30)

   (b) Accounting for upfront commission costs (paragraphs 31 – 40)

      (i) Summary of respondent feedback (paragraph 34)

      (ii) Staff analysis (paragraphs 35 – 39)

      (iii) Staff recommendation (paragraph 40)

Accounting for performance fees

5. One type of fee an asset manager frequently receives is a performance-based incentive fee, which varies based on the extent by which the fund's investment performance exceeds a benchmark index. Current US GAAP in ASC 605-20-S99-1 *SEC Staff Announcement: Accounting for Management Fees Based on a Formula* (formerly EITF D-96) prescribes two acceptable methods for accounting for these types of performance fees. Those methods are referred to as 'Method 1' and 'Method 2' and are described as follows:

   (a) **Method 1**- performance fees are recognized once the services are performed and all contingencies have been resolved (which generally results in the revenue not being recognized until the end of a specified measurement period or a contract).

   (b) **Method 2**- performance fees are recognized throughout the contract measured based on the amount that would be due from the customer (calculated using a prescribed formula) assuming the contract was

terminated at that date (ie liquidation value). Method 2 can be used to recognize revenue only if the contract contains a termination provision.

6. The terms ‘Method 1’ and ‘Method 2’ are commonly understood in the asset management industry and were included in the feedback received. Therefore, the remainder of this paper uses these terms (ie ‘Method 1’ and ‘Method 2’) to describe current and proposed accounting treatment of these performance fees.

7. To illustrate the two methods, consider the following example:

> An asset manager enters into a one-year contract with a customer to provide investment management services. The asset manager is paid a fixed fee per month plus a performance-based incentive fee equal to 10 percent of the fund’s return in excess of the return on the S&P for the year. The contract can be terminated by either party with reasonable notice at the end of each quarter. In the event of a termination, the amount due for the performance-based incentive fee will be calculated at the termination date based on the fund and S&P 500 returns to date. Assume the fund’s returns exceed/(are lower than) the returns of the S&P 500 by:
>
> - CU100,000 in the first quarter
> - CU50,000 in the second quarter
> - CU10,000 in the third quarter
> - (CU50,000) in the fourth quarter
>
> Thus, the total return of the fund for the year exceeds the S&P 500 return by CU110,000.

8. Applying Method 1 to the facts in the above example, the asset manager would be precluded from recognizing revenue from the performance-based fee at the end of the first three quarters because, at those times, all contingencies have not been resolved (ie the performance-based fee will ultimately be determined based on the fund’s return in excess of the return on the S&P *for the year*). Therefore, applying Method 1, the asset manager would recognize CU11,000 from its performance-based fee (CU110,000 * 10%) only at the end of the year (ie when all the contingencies related to the performance-based incentive fee are resolved).

9. Alternatively, applying Method 2 to the facts in the above example and calculating the amount due as if the contract was terminated at the end of each quarter, the asset manager would recognize/(reverse) the following amounts of revenue at the end of each quarter:

   First quarter = CU10,000 (CU100,000 * 10%)

   Second quarter = CU5,000 (CU50,000 * 10%)

   Third quarter = CU1,000 (CU10,000 * 10%)

   Fourth quarter = (CU5,000) [(CU50,000) * 10%]

10. The staff note that the SEC have provided a view on 'Method 1' and 'Method 2' in ASC 605-20-S99-1 as follows:

   > The SEC staff would not object to either Method 1 or Method 2 as described above; however, the SEC staff considers Method 1 to be the preferable accounting policy. The SEC staff believes that Method 1 is more consistent with the analysis presented in Staff Accounting Bulletin Topic 13.A, which states that "the staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved." Furthermore, Method 1 eliminates the potential that revenue will be recognized in one quarter and reversed in a future quarter.
   >
   > The SEC staff also would not object to Method 2. The calculated revenue may be viewed as realizable at an interim date due to the termination provisions in the arrangement. Furthermore, this approach results in revenue recognition that reflects the performance of the manager—revenue is higher in periods in which the manager's performance has exceeded the specified performance target(s), while revenue is lower in periods in which the manager's performance has not exceeded the specified performance target(s). This method also does not involve a consideration of future performance, as it

relies only on the calculated fee at the interim measurement date.

11. Under IFRSs, there is no comparable industry-specific guidance and asset managers currently apply IAS 18, *Revenue*. The staff understand that entities applying IFRSs may sometimes recognize revenue throughout the period based on a liquidation value for the fund (ie Method 2 under US GAAP). That is because, in those cases, the entity has concluded that the fair value of the consideration (ie the performance-based fee) can be measured reliably at each reporting date, and the other revenue recognition criteria in IAS 18 are met. However, the staff understand that in the majority of cases of performance-based fees, entities applying IFRSs have concluded that the fair value of consideration (ie the performance-based fee) is *not* reliably measurable and, therefore, revenue cannot be recognized until all of the contingencies are resolved at the end of the measurement period or the contract (ie Method 1 under US GAAP).

12. The staff also understand that the majority of non-alternative asset managers (ie those managing mutual funds subject to the Investment Company Act of 1940) in the US recognize revenue in accordance with Method 1. However, alternative asset managers (ie those managing private equity and hedge funds that are exempt from the Investment Company Act of 1940) in the US are split between Method 1 and Method 2.

Proposed requirements in the 2011 ED

13. Performance-based incentive fees are a form of variable consideration and, therefore, consistent with the Boards' tentative decisions, would be subject to the constraint on revenue recognized. During the November 2012 joint Board meeting, the Boards tentatively decided that the revenue standard should state that the objective of the constraint is for an entity to recognize revenue at an amount that should not be subject to significant revenue reversals. The Boards also tentatively decided to retain the indicators in paragraph 82 of the 2011 ED which highlight circumstances in which a revenue reversal could occur. Paragraph 82 states (in part):

> Indicators that an entity's experience (or other evidence) is not predictive of the amount of consideration to which the entity will be entitled include, but are not limited to, the following:
>
> (a) The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

14. Since the amount of the performance fees would be affected by volatility in the market, the staff think that indicator (a) in paragraph 82 of the 2011 ED would typically preclude an asset manager from recognizing revenue from these fees until the volatility is resolved (consistent with Method 1). Therefore, the staff think that applying the constraint in the 2011 ED would mean that an asset manager typically could not recognize revenue from performance fees in accordance with Method 2.

15. Additionally, the staff note that the Boards included in the implementation guidance, Example 13 – Management fees, which states (in part):

> The entity concludes that it is not reasonably assured to be entitled to the incentive fee until the end of the year. Although the entity has experience with similar contracts, that experience is not predictive of the outcome of the current contract because the amount of consideration is highly susceptible to volatility in the market. In addition, the incentive fee has a large number and high variability of possible consideration amounts.

Summary of respondent feedback

16. Some respondents, primarily preparers in the alternative asset management industry, disagreed with the result achieved by applying the constraint to these performance fees (which would preclude the use of Method 2) because, in their

view, it does not faithfully report the economics of their transactions. These respondents noted that recognizing revenue only once all contingencies have been resolved does not faithfully represent an asset manager's performance over a given reporting period and, thus, does not provide investors with the most useful information.

> We do not agree with the proposed constraint on the amount of revenue that an entity would recognize for satisfied performance obligations. As discussed in the General Comments section above, such constraint does not give users of asset manager financial statements any indication of the manager's performance during a given period. We note that there has been an increasing use of fair value concepts in U.S. GAAP and recognizing performance based fees, including carried interest, taking into account the fair value of underlying investments provides a more accurate reflection of revenue earned in that period. (CL#152 The Blackstone Group)

17. One respondent who disagreed with the outcome of applying the constraint to these performance fees (ie that would preclude the use of Method 2) also disagreed with the effect this would have on the income statement because the related compensation expense (paid to employees to earn the performance fees) is recognized throughout the period as incurred. (Currently, asset managers that apply Method 2 recognize the compensation expense in the same period as the performance fee.) This respondent suggested that if the Boards decide to preclude the use of Method 2, then the Boards should consider a deferral of the related compensation expense to avoid a mismatch of revenues and expenses.

18. The staff also conducted outreach with analysts in the asset management industry. The majority of these analysts were in favor of recognizing the performance fees as revenue when the fees are realized (ie Method 1), and supported the 2011 ED's proposed change to the way that alternative asset managers would recognize revenue. Those in favor of applying the constraint to the performance fees cited that they would rather asset managers be conservative instead of recognizing

revenue that may reverse in future periods. In addition, they noted that the proposed change would result in improved comparability both within the alternative asset managers and with the traditional asset managers.

19. On the other hand, some analysts in the alternative asset management industry stated that they prefer Method 2 because it gives a better depiction of the fund's value and the asset manager's performance. These analysts noted that showing the accruals in quarterly reports is important because the performance fees are material. These analysts said that the accruals are one of the most asked about numbers by investors.

20. Although the majority of analysts supported applying the constraint in the 2011 ED to an asset manager's performance fees (ie Method 1), these analysts stated that regardless of what method the Boards decide to include in the final revenue standard, information is needed about both Method 1 and Method 2 in the form of disclosures.

Staff analysis

21. The staff think there are two alternatives to accounting for an asset manager's performance-based incentive fees:

    View A – retain the proposals in the 2011 ED (as amended in the November 2012 joint Board meeting); or

    View B – amend the constraint on revenue recognition.

22. The staff considered a third alternative to exclude these fees from the scope of the revenue standard or from the application of the constraint guidance. Some respondents suggested this alternative because, in their view, the asset management contract is more like an equity investment or another financial instrument. However, the staff rejected this alternative because the asset manager is providing services that should be within the scope of the model. In addition, it would create complexity and would require the Boards to clearly define the population of fees that would be excluded from the scope of the proposals. Furthermore, in the absence of other directly applicable guidance, the Boards

would likely then be requested to determine an appropriate alternative accounting for these fees.

23. The staff note that selecting either View A or View B would promote comparability among asset managers. Under current practice, comparability of entities within the asset management industry is diminished because some entities use Method 1 and some entities use Method 2. However, these alternatives would require the use of either Method 1 or Method 2 based on the characteristics of the contract.

View A – retain the proposals in the 2011 ED

24. Retaining the proposals in the 2011 ED would mean that asset managers should apply the constraint on revenue recognition to their performance fees. This means that revenue would be recognized only when market volatility will not cause a significant revenue reversal (ie Method 2 could not be used to recognize revenue). The staff think that this outcome would be generally consistent with that achieved by applying Method 1.

25. The staff note the following about retaining the proposals in the 2011 ED:

    (a) This alternative is consistent with the accounting for other contracts with incentive fees for which the Boards decided that revenue should be recognized only when the amount is not subject to a significant revenue reversal. User feedback has broadly expressed a preference for revenue to be recognized only after contingencies have been resolved.

    (b) This alternative is consistent with current practice for a majority of asset managers applying IFRSs. As explained in paragraph 11, the majority of asset managers currently applying IFRSs do not recognize revenue until all of the contingencies are resolved at the end of the period or the contract (ie Method 1 under US GAAP).

    (c) Applying the constraint to performance fees reduces the short-term volatility in revenue. As illustrated in the example in paragraph 7, recognizing the performance fees in accordance with Method 2 resulted

in various amounts being recognized as revenue each quarter, including a reversal of revenue in the fourth quarter. However, recognizing the performance fees in accordance with Method 1 resulted in a single amount being reported in the fourth quarter, thereby eliminating the volatility in the year's revenue.

(d) However, the pattern of revenue recognition may not give a good depiction of the entity's performance because an entity would not be able to recognize revenue from performance fees until all contingencies are resolved. Often times, the longer that an asset manager must wait to recognize revenue under Method 1, the greater the amount of revenue that the asset manager will ultimately recognize once the contingencies are resolved. Therefore, the revenue of an asset manager may be skewed towards the latter portion of the contract.

(e) In a separate paper on disclosures, the staff will consider whether to include a disclosure about revenue that has not been recognized due to the constraint. The staff note additional disclosures consistent with a Method 2 application would not be precluded. Thereby, entities wanting to provide such information in their financial statements would be able to do so.

View B – amend the constraint on revenue recognition

26. View B proposes to amend the constraint on revenue recognized to require the recognition of revenue consistent with Method 2 if certain criteria are met. Under this alternative, the following would be added to paragraph 81 of the 2011 ED:

> However, if the contract contains a termination provision that gives an entity contractual rights to consideration before the end of the measurement period specified in the arrangement and this consideration is indexed to a market, then the amount of revenue recognized would be equal to the liquidation value of the contract as if the contract was terminated at that date.

27. Amending the constraint in this manner would require an asset manager that meets the criteria proposed in paragraph 26 to recognize revenue in accordance with Method 2 (ie this would preclude the use of Method 1 in these cases). The staff want to articulate that the amount of revenue recognized would be equal to the liquidation value of the contract – the staff note this is not the same as fair value.

28. The staff note the following about amending the constraint:

    (a) An asset manager's financial statements would better reflect the changes in a fund's fair value from period to period and, therefore, better reflect the asset manager's performance. Supporters view this as an advantage of this alternative because it gives users a clear depiction of the interim performance of a fund and, thus, an asset manager's performance. On the other hand, some view this as a disadvantage because revenue is more volatile and subject to future reversal.

    (b) Recognizing revenue in accordance with this alternative would not create a mismatch between the timing of the recognition of the performance fees as revenue and the corresponding compensation expense. As described in paragraph 17, the portion of the fees allocated to employees as compensation expense is expensed as incurred.

    (c) This amendment may apply more broadly than to just those entities in the asset management industry and could result in unintended consequences. However, because the proposed amendment is limited to consideration tied to a market index, the staff do not think the unintended consequences would be widespread. In addition, the revenue standard would need to clearly articulate whether the termination clause would need to be explicit, or whether an implicit termination clause would have the same effect.

Staff recommendation

29. The staff recommend View A – that is to retain the constraint proposals in the 2011 ED. Although View B gives a good depiction of the entity's period to period performance in this industry, its rationale is arguably not consistent with the basis of the constraint. That is because the objective of the constraint is to recognize revenue at an amount that should not be subject to significant revenue reversals. In addition, View B creates a risk of unintended consequences and the revenue standard would need to clarify whether termination clauses would need to be explicit. Furthermore, a number of entities are currently applying Method 1 to determine when to recognize revenue, particularly those who are applying IFRSs.

30. Retaining the proposals in the 2011 ED would mean that asset managers should apply the constraint to their performance fees. This means that revenue would be recognized only when market volatility will not cause a significant revenue reversal (ie Method 2 could not be used to recognize revenue). The staff think that this outcome would be generally consistent with that achieved by applying Method 1.

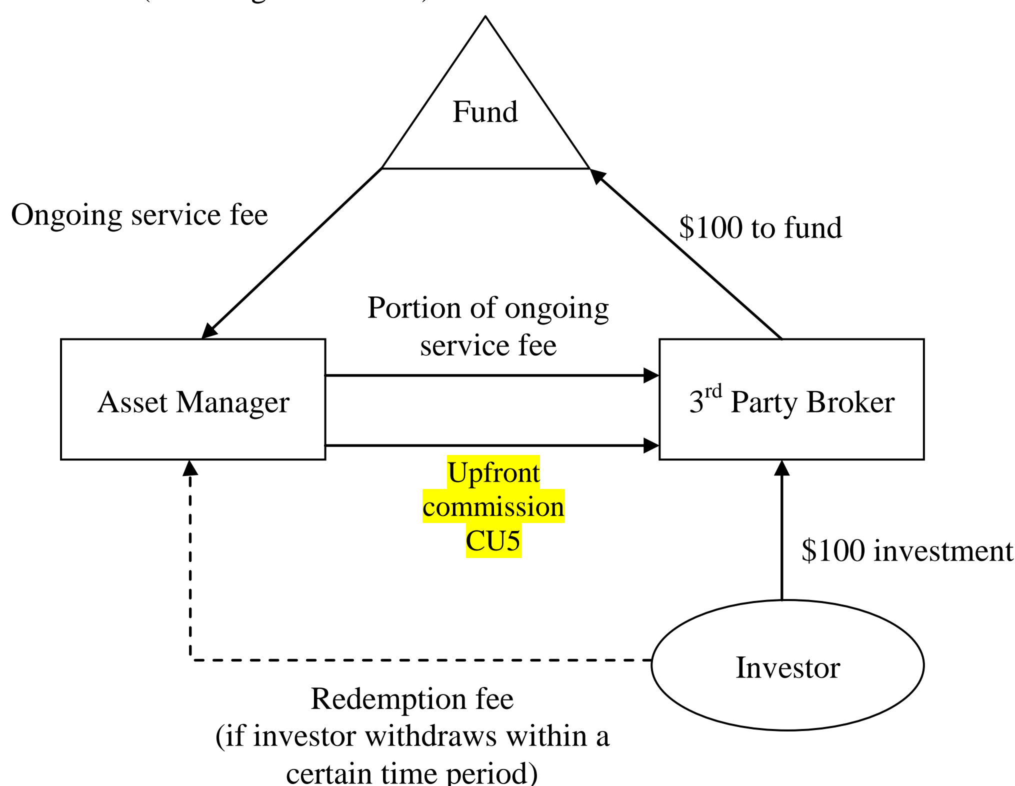
Question 1 – Accounting for performance fees
Do the Boards agree with the staff's recommendation to retain the constraint proposals in the 2011 ED for recognizing revenue from performance-based incentive fees for asset managers?

Accounting for upfront commission costs

31. There are several different structures and transactions within the asset management industry. A number of respondents raised questions regarding costs incurred in an arrangement between an asset manager and a fund, where the asset manager agrees to provide various services to the fund. These services include (but are not limited to) investment management and distribution services. The questions raised by respondents centered around how to account for the upfront commission costs incurred by an asset manager in the distribution service

contract. The distribution service includes marketing and selling the fund shares. The staff note that the following description and diagram relate to the distribution service (not the investment management service) provided by the asset manager.

32. One type of investment fund offered by an asset manager is known as a 'back-end load' fund. In this type of fund, the asset manager pays an upfront commission to a third-party broker (refer to CU5 upfront commission in diagram), who arranges for an investor to invest money into a fund. Upon the investor's initial investment, there is no payment to the asset manager. The fund pays an ongoing service fee to the asset manager, who then remits a portion of this ongoing fee to the broker. In a back-end load fund, if the investor withdraws from the fund within a specified time period (usually 6-8 years), then the investor must pay the asset manager a redemption fee, which represents a percentage of the assets in the fund at the time of withdrawal. The following diagram illustrates the distribution services (ie selling fund shares) associated with a 'back-end load' fund.



33. Current US GAAP in ASC 946-605-25-8 (formerly EITF 85-24) allows asset managers to capitalize and amortize the upfront commissions paid to third-party brokers (referred to as 'deferred incremental direct costs' below). The guidance

does not make the distinction about whether the incremental direct costs are contract acquisition costs or fulfillment costs. ASC 946-605-25-8 states:

> Distributors of mutual funds that do not have a front-end sales fee receive fees that are designed to compensate them for the distribution of fund shares. The fees are sometimes received over a specified future period. The cost deferral method shall be used, that is, the fees shall be recognized when received, **the deferred incremental direct costs shall be amortized,** and the indirect costs shall be expensed when incurred.

Summary of respondent feedback

34. The FASB proposed to remove the existing US GAAP on this topic (cost guidance in Topic 946 on financial services – investment companies) in the proposed amendments to the *FASB Accounting Standards Codification* in the 2011 ED. As a result, some respondents in the US questioned the accounting for the upfront commission incurred by the asset manager in a back-end load fund. These respondents requested that the FASB retain the existing guidance.

Staff analysis

35. The staff note that accounting for contract costs was not a primary objective of the revenue recognition project. Rather, the proposed guidance specifies the accounting for contract costs that are not within the scope of other standards. Unlike Topic 946, the 2011 ED makes the distinction between contract acquisition costs and fulfillment costs. Since there is a wide spectrum of asset management arrangements, the terms and conditions of these arrangements could result in the upfront commission costs paid by an asset manager in a back-end load fund being interpreted as either fulfillment costs or contract acquisition costs. The staff note that this distinction revolves around whether the distribution and investment management services provided by the asset manager are accounted for as separate performance obligations or a single performance obligation. Additionally, the

assessment is impacted by who is determined to be the customer in these arrangements, the fund or the individual investor.

36. The staff think there are two interpretations as follows:

    (a) distribution service is a separate performance obligation apart from the investment management service; and

    (b) investment management service is the performance obligation and distribution service is a supporting activity within that performance obligation.

37. Assuming that the distribution and investment management services are accounted for as separate performance obligations, the distribution service of obtaining a new investor is satisfied (ie fulfilled) upon the investor's initial investment into the fund, and thereby expensed in accordance with the 2011 ED's fulfillment cost guidance. Constituents raised concerns of how this interpretation of the 2011 ED would change current practice in the absence of the industry-specific guidance in Topic 946. The staff think it was not the Boards' intent to change the existing industry-specific fulfillment cost guidance, which under US GAAP, in accordance with Topic 946, would require the capitalization of these upfront commission payments.

38. Assuming that the distribution and investment management services are accounted for as a single performance obligation, effectively the substance of the distribution service is to obtain a new investor in order to provide investment management services. The upfront commission is an incentive paid to obtain investors to invest in the fund, which would increase the fund's assets and thereby increase the management fee to which the asset manager is entitled (because the management fee is determined in proportion to the assets under management). This upfront commission is economically similar to other commissions paid by entities operating in other industries – that is, the commission is an incremental cost that is incurred upon obtaining a new contract/investment, which directly and positively affects the entity's future revenue. In this interpretation, the upfront commission paid to acquire an investor may be viewed as an incremental cost to

obtain a contract, which would be capitalized in accordance with paragraph 94 of the 2011 ED.

39. The staff think these costs would be capitalized under either interpretation for US GAAP, absent the consequential amendment that removed the Topic 946 cost guidance.

Staff recommendation

40. Based on the analysis above, the staff think that all of the facts and circumstances in each asset management arrangement should be assessed when determining whether these costs are contract acquisition costs or fulfillment costs. As a result, the staff do not recommend that the Boards make any changes to the contract cost proposals in the 2011 ED. In addition, as the outcome would be the same under either interpretation for US GAAP, for the avoidance of doubt, the staff recommend that the FASB retain the cost guidance in Topic 946 on financial services – investment companies.

Question 2 – Accounting for upfront commission costs
(a) Do the Boards agree with the staff's recommendation that no changes should be made to the contract cost proposals in the 2011 ED? (b) FASB only – Does the FASB agree with the staff's recommendation to retain the cost guidance in Topic 946 on financial services – investment companies?