No. 2014-13
14 August 2014

Technical Line

FASB — final guidance

The new revenue recognition standard — asset management

In this issue:

What you need to know

- The FASB and the IASB have issued a new principles-based revenue recognition standard that will likely change when certain fees are recognized by asset managers and the accounting for certain costs.
- Under the new guidance, performance-based fees will not be recognized until it is probable that a significant reversal in the amount of cumulative revenue will not occur.
- Current industry guidance requiring distributors of mutual funds with no front-end sales load to defer and amortize incremental direct distribution costs has been retained.
- The new standard requires a number of new disclosures that may create additional data needs.
- The new guidance is effective in the first quarter of 2017 for calendar year-end public entities and in 2018 for nonpublic entities.

Overview

Asset managers 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 (the FASB) and the International Accounting Standards Board (the IASB) (collectively, the Boards).

The new standard affects all asset managers that enter into contracts to provide services to their customers. Among the more significant potential changes are the accounting for performance-based fees and contract costs. The new guidance constrains the amount of revenue to be recognized to amounts for which it is probable that there will not be a significant reversal in the amount of cumulative revenue recognized and provides factors to consider in making that determination.

Asset managers that today follow the Securities and Exchange Commission (SEC) staff's guidance in Accounting Standards Codification (ASC) 605-20-S99[1] are not subject to such a constraint. The SEC staff's guidance allows them to recognize performance fees on an "as if realized basis," which is the amount that would be due if the contract were terminated and the fund liquidated at the reporting date (also referred to as Method 2). The SEC staff has not yet indicated whether the guidance in ASC 605-20-S99 will be rescinded.

The accounting for certain contract costs may also change for some asset managers. Under the new standard, incremental costs of obtaining a contract and certain direct fulfillment costs will be recognized as assets if the costs are expected to be recovered. Such costs will need to be evaluated for impairment.

Applying the new standard will require a number of judgments and estimates based on the individual facts and circumstances. For example, as described later, identifying the customer is important because that identification will affect when any up-front fees are recognized and the accounting for contract costs.

To support stakeholders with implementation of the new standard, the Boards have established a Transition Resource Group (TRG). The TRG was created to help the Boards determine whether more guidance or education is needed on implementation issues and other matters submitted by stakeholders. The TRG won't make formal recommendations to the Boards or issue guidance. Separately, the American Institute of Certified Public Accountants (AICPA) has established 16 different industry working groups to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views or guidance produced by the TRG or AICPA are non-authoritative.

This publication provides an overview of the new revenue recognition model, highlights potential changes from current practice and discusses other implications and potential issues to consider when implementing the new standard. The views expressed in this publication are preliminary. Additional issues may be identified as the standard is analyzed and entities begin to interpret it, and our views may evolve during that process. This publication should be read in conjunction with our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771).

Summary of the new model

The Boards jointly issued a new revenue recognition standard that will supersede virtually all existing revenue guidance under US GAAP and IFRS.

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

An entity will need to exercise judgment when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances.

Background and scope

Asset managers typically enter into a variety of contracts to provide advisory and other services to investment vehicles, such as hedge funds, private equity funds and mutual funds. While the legal forms of the arrangements vary, these vehicles generally provide for investor capital to be pooled and invested to earn a return. Hedge funds typically do not have a stated life and allow investors to subscribe to and redeem from the funds at specified dates. Private equity funds generally have a stated life (e.g., 10 years), and investors that commit capital to the fund cannot redeem their investments. Both hedge funds and private equity funds typically pay base management fees and performance-based fees to the general partner/investment manager/adviser.

Mutual funds typically do not have stated lives and generally do not pay performance-based fees. Mutual funds have added complexities because they also often have agreements with distributors, brokers and other service providers. Mutual funds are subject to the Investment Company Act of 1940 and are overseen by a board of directors.

The standard applies to all entities' contracts with customers to provide goods or services in the ordinary course of business.

Primary fee arrangements include:

- Base management fees (hedge funds, private equity funds and mutual funds)
- Performance-based fees (hedge funds and private equity funds)
- Reimbursement of certain start-up or ongoing costs (potentially all three fund types)
- Distribution and related fees (mutual funds)

The principles underlying each of the model's five steps are discussed in the following sections and are illustrated using a hypothetical arrangement between a hedge fund (Fund), general partner (GP) and an investment manager. As background, a hedge fund in the form of a partnership typically has a GP that has the power to manage the assets and business of the fund for the fund's limited partners (LPs). An investment manager related to the GP often manages the assets. The following summarizes key terms of the hypothetical arrangement.

Illustration 1 — Hypothetical scenario assumptions
An asset manager provides services to a hedge fund through two wholly owned entities: a GP and an investment manager to which certain management functions are assigned. The investment manager earns a management fee that is invoiced and payable quarterly based on 0.5% of the Fund's ending net asset value (NAV) (i.e., a 2% annual fee). The GP is entitled to a performance-based incentive fee on 31 December of 20% of any year-over-year increase in the Fund's NAV. Assume that the GP interest is in the scope of the new guidance and the GP does not consolidate the Fund. There are no LP subscriptions or redemptions during the year.

Identify the contract with a customer

To apply the model, an entity must first identify the contract(s) and customer(s). Any arrangements with a customer that create enforceable rights and obligations are considered contracts under the standard and should be evaluated. Properly identifying the customer is important because revenue is recognized only when performance obligations in contracts with customers are satisfied.

Consider a mutual fund. A mutual fund is a regulated legal entity that structurally resembles a corporation. A mutual fund typically has a board of directors (including independent members who must periodically approve certain matters) and shareholders. A mutual fund generally has no employees and contracts with parties to obtain services.

Under one such contract, a mutual fund will contract with an adviser to obtain investment services for the benefit of the mutual fund's shareholders, who are not a party to that contract. Assuming that the investment adviser is not required to consolidate the mutual fund and the mutual fund has more than a limited number of investors, the mutual fund (and not the mutual fund's shareholders) may be viewed as the adviser's customer. Contracts with a mutual fund to provide underwriting (distribution), custodian and transfer agent services may be evaluated similarly.

In contrast, consider a hedge fund established by a GP for one LP. In this case, it may be reasonable to conclude that the LP is the customer.

The identification of the customer will affect the accounting for up-front fees and certain costs.

How we see it

The terms of an arrangement should be evaluated carefully to identify the customer. The proper identification of the customer is important because of the potential for differences in accounting for fees from front-end sales loads and costs of obtaining a contract, among others.

Combining contracts

The standard requires two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) 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).

Illustration 2 — Identify the contract with a customer

Based on the assumptions in Illustration 1, the asset manager should combine the management contract and GP interest for revenue recognition purposes because:

- The contracts are negotiated together with a single commercial objective.
- The contracts' pricing is interdependent because the incentive fee is calculated as 20% of the increase in the NAV, which is reduced by the management fee.
- The services promised in the contracts are generally a single performance obligation (i.e., while there are separate contracts entitling the asset manager to different types and amounts of compensation, there generally is one underlying service, which is the management of the Fund's assets).

How we see it

The standard requires that contracts with the same customer be combined when one or more of the criteria are met. Accordingly, while service contracts may have economic differences (e.g., the management fee is based upon NAV while the incentive fee is based only on increases in NAV), the contracts should be combined if the underlying service is a single performance obligation. Determining whether contracts should be combined will depend on the facts and circumstances and will require judgment.

Although the requirement to combine contracts is generally consistent with the underlying principles in today's guidance, entities should carefully evaluate whether any of the criteria to combine contracts are met when applying the new standard.

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.

Management of the fund (compensated by both base and incentive management fees) will generally be considered a single performance obligation.

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).

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.

Certain services provided to investment funds (e.g., investment management services) are provided continuously over the contract period, so the services in the contract will generally represent a single performance obligation comprising a number of distinct service periods (e.g., quarters, months).

Example 25 (ASC 606-10-55-221 through 55-225) of the standard illustrates this concept by describing a five-year investment advisory contract that entitles the investment manager to both a quarterly management fee and an incentive fee that is based on cumulative results over the five-year term of the contract. The example concludes that the management services are a single performance obligation because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer.

Illustration 3 — Identify the performance obligations in the contract
Based on the facts in the previous illustrations, there is a single performance obligation that is a series of distinct goods or services (management activities) that are substantially the same and have the same pattern of transfer. Although there are two separate forms of compensation, there is generally only one service, which is the management of the Fund's assets. An asset manager generally does not offer either base management services or performance-based services separately. As a result, the Fund generally cannot benefit from either the base management service or the performance-based service with another service that is readily available. Therefore, the performance-based service and the base management service would not be considered distinct from each other.

Other fee arrangements

Other fee arrangements between funds and their service providers also will need to be analyzed to identify all promised goods or services and to determine what (if any) separate performance obligations exist. Distinct performance obligations cannot be combined unless the separate performance obligations 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. As a result, services that are not substantially the same should not be combined, even if they have similar terms and the basis for determining the compensation is the same underlying (e.g., NAV).

Other fee arrangements include (1) distribution agreements with mutual funds and (2) the reimbursement of start-up costs. These items are discussed later in this publication.

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., variable fee arrangements such as management fees and incentive fees), 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 the constraint described below) will be estimated using either an expected value method (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. The estimated transaction price is required to be updated at each reporting date.

Constraining estimates of variable consideration

The amount of variable consideration an entity can include in the transaction price is constrained to the amount for which it is probable that a significant revenue reversal will not occur when the uncertainty is resolved. In making this determination, both the likelihood and the magnitude of a revenue reversal should be considered. The constraint on variable consideration focuses on reversals that would be significant when compared with the cumulative amount of revenue, 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 also provides factors to consider 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., volatility in a market). Other factors include when the entity's experience with similar contracts is limited or has little predictive value, the contract has a large number and broad range of possible consideration amounts and the uncertainty is not expected to be resolved for a long period of time.

The presence of these factors does not necessarily mean that variable consideration can't be included in the transaction price (note the Boards' use of the term "factors" rather than "criteria"), but entities should carefully evaluate the application of the constraint when these factors exist.

Base management fees

For base management fees based on each period's NAV, the transaction price will generally include the amount determined at the end of the period(s). Estimates of future period management fees would generally not be included in the transaction price because these estimates would be constrained.

Performance-based fees

Performance fees based on a hedge fund's net asset value or the realized appreciation of a private equity fund's investments are types of variable consideration. In many cases, these performance fees are highly susceptible to market volatility until they are crystallized (at the end of a hedge fund's performance period) or no longer subject to clawback (at the termination of the private equity fund). Under a clawback provision, a GP may be required to return certain distributions received from the fund if a specific performance threshold is not met.

Under current practice, entities that recognize revenue in accordance with Method 1 of ASC 605-20-S99 do not recognize performance-based fees until all contingencies have been resolved. Current US GAAP also permits performance-based fees to be recognized as revenue based on the amount that would be due to the manager if the contract were terminated and the fund liquidated at the reporting date (Method 2). As such, entities using Method 2 generally recognize revenue from performance-based fees earlier than entities using Method 1.

Because the new standard prohibits the recognition of variable consideration as revenue until it is probable that a significant reversal of the cumulative amount of revenue recognized will not occur upon the resolution of the uncertainty, entities that account for their variable incentive-based fees under current Method 2 generally will recognize revenue from their incentive fee arrangements later under the new standard than they do under current practice.

Example 25 in the standard discusses a performance-based incentive fee that is based on a fund's return over a defined period and concludes that an estimate of the variable consideration, both at contract inception and at subsequent reporting dates, should be excluded from the transaction price because the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue will not occur. This is because the performance-based incentive fee depends on the market and, thus, is highly susceptible to factors outside the entity's influence. The example also indicates that although an entity may have experience with similar contracts, that experience has little predictive value.

However, the language in the standard (i.e., the Boards' use of the term "factors" rather than "criteria") leaves open the possibility that asset managers in certain circumstances may be able to recognize revenue from performance-based fees sooner than they would under today's Method 1. The standard does not provide specific guidance to make that determination. However, some factors an asset manager of a private equity fund could consider in determining whether it is probable that a significant reversal of the cumulative amount of revenue recognized will not occur include whether:

- The fund is near final liquidation.
- The fair value of the remaining assets in the fund is significantly in excess of the threshold at which the manager would earn an incentive fee.
- The remaining assets in the fund are low risk.
- The fund's remaining investments are under contract for sale with purchase prices that would result in no clawback.

A manager might consider other factors in its assessment. No single consideration is determinative, and likely, some combination of the factors above and others will need to exist in order to conclude that it is probable that a significant reversal in the cumulative amount of revenue will not occur. This evaluation will require significant judgment and will need to be made based on the individual facts and circumstances. An asset manager that concludes that it is probable that some amount of the incentive fee will not be reversed will recognize that amount as revenue.

An entity includes variable consideration in the transaction price only to the extent that it is probable that a significant reversal of revenue will not occur.

Illustration 4 — Determine the transaction price

Because the quarterly management fee and the annual performance fee are determined by reference to NAV, they represent variable consideration. After considering various factors, including that the fees are subject to market volatility and a broad range of outcomes, assume the GP and the investment manager are unable to conclude before the NAV is determined at the end of the quarter (for the management fee) and 31 December (for the performance fee) that it is probable that a significant revenue reversal will not occur.

As a result, estimated quarterly management and incentive fees expected to be earned for the rest of the year will not be included in the transaction price (i.e., will be constrained). The estimated variable consideration is reassessed at each reporting date. Therefore, the transaction price at each quarter end is the amount that is no longer subject to market volatility.

Assume that the Fund's NAV at the beginning of the year is $100,000, and there have been no LP subscriptions or redemptions since that date. For simplicity, assume the management fee is based on the end-of-quarter NAV, which is presented in the following table. As a reminder, the incentive fee is receivable based on the 31 December NAV. The transaction price as of each quarter end could be estimated as follows:

			Estimated transaction price		
Period	NAV	Management fee received	Management fee	Incentive fee	Total
Q1	$ 100,000	$ 500	$ 500	$ -	$ 500
Q2	300,000	1,500	2,000	-	2,000
Q3	50,000	250	2,250	-	2,250
Q4	150,000	750	3,000	10,000	13,000

How we see it

The new standard doesn't change ASC 605-20-S99, which contains the SEC staff guidance permitting performance fees to be recognized on an "as if realized basis." This is the amount that would be due if the contract were terminated and the fund liquidated at the reporting date (also referred to as Method 2). The SEC staff has not yet indicated whether the guidance in ASC 605-20-S99 will be rescinded.

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, the transaction price is generally allocated to the performance obligations 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. The objective is to allocate the transaction price to each performance obligation in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.

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 standard states 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 two exceptions to the relative standalone selling price method of allocating the transaction price. Under one of these exceptions, variable consideration is allocated entirely to a specific part of the contract, such as one or more (but not all) performance obligations in the contract, or one or more (but not all) distinct goods or services that form part of a single performance obligation, if certain criteria are met. Essentially, as a result of this exception, the variable consideration is not allocated across all performance obligations or all distinct goods or services that form part of a single performance obligation.

In order to allocate variable consideration in this manner, both of the following criteria must be met: (1) the terms of the variable payment relate specifically to the entity's efforts to satisfy a specific performance obligation or transfer a distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service) and (2) allocating the variable consideration entirely to a performance obligation or the distinct good or service depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised good or service.

Illustration 5 — Allocate the transaction price to the performance obligations in the contract
The performance obligation for the fact pattern described in the previous illustrations is a series of distinct goods or services (quarterly services) that form part of a single performance obligation. Thus, the transaction price (which comprises only the variable consideration related to the management fee, unless it is probable that the performance fees won't be subject to significant reversal) is allocated to each individual quarter (i.e., the distinct services within the performance obligation) because the management fee relates specifically to the entity's efforts to provide management services during the quarter, and the allocation is consistent with the objective of allocating an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised services.

How we see it

If the criteria described previously are met, variable fees (whether base management fees or performance-based incentive fees) in multi-year contracts will be allocated entirely to distinct service periods that have already occurred (e.g., prior quarters) once they are no longer subject to a significant revenue reversal. That is, once an entity determines that a variable fee should be allocated to distinct services that form part of a single performance obligation, the unconstrained portion of the fee is included in the transaction price and allocated to completed service periods if the terms of the payment relate specifically to the entity's efforts to transfer the service in those periods and the amount allocated represents the consideration to which the entity expects to be entitled for services performed. Allocating the transaction price to the performance obligations or to the distinct goods or services that form part of a single performance obligation will depend on the individual facts and circumstances.

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 goods or services are 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. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

An entity transfers control of a good or service over time (and, therefore, recognizes revenue over time) if any of the following criteria are satisfied: (1) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs, (2) the entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced or (3) 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.

Investment management services are generally satisfied over time because either the customer simultaneously receives and consumes the benefits provided by the asset manager as the asset manager performs the service, or the asset manager's performance enhances the assets that the fund controls. When a performance obligation is satisfied over time, the standard requires an entity to select a single method of measuring progress for each performance obligation that depicts the entity's performance in transferring control of 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 the input method, revenue is recognized based on the ratio of efforts already expended relative to the total efforts expected to be expended. Under the 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, time elapsed and units produced or delivered.

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 bills a fixed amount for each hour of service provided).

Illustration 6 — Recognize revenue when the entity satisfies a performance obligation

Based on the estimated transaction prices described previously, management fees and incentive fees will be recognized under the output method as follows:

Period	NAV	Management fee	Incentive fee	Estimated transaction price at quarter end	Revenue recognized	
					New Standard	Method 2
Q1	$ 100,000	$ 500	$ -	$ 500	$ 500	$ 500
Q2	300,000	1,500	-	2,000	1,500	41,500
Q3	50,000	250	-	2,250	250	(39,750)
Q4	150,000	750	10,000	13,000	10,750	10,750
				Total	$ 13,000	$ 13,000

Note: The $40,000 (($300,000 − $100,000) x 20%) of incentive fees would be deemed earned under Method 2 in the second quarter under a hypothetical liquidation of the fund and subsequently reversed in the third quarter due to a lower NAV. Under the new model, the incentive fee would not be included in the transaction price in the second quarter because, in the example, the entity was not able to assert that it is probable a significant revenue reversal will not occur. This conclusion was discussed previously in Illustration 4. For purposes of this example, the pattern of revenue recognition under the standard and Method 1 is the same.

Other considerations

Contract costs

The standard also provides guidance to account for an entity's costs incurred in (1) obtaining and (2) fulfilling a contract to provide goods and services to customers.

Costs to obtain a contract

Incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) will be recognized as an asset if the costs are expected to be recovered. Costs can be recovered directly (i.e., through reimbursement under the contract) or indirectly (i.e., through the 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. An impairment loss will be recognized if the carrying amount of any asset exceeds the amount of consideration the entity expects to receive in exchange for providing those goods or services, less the remaining costs that relate directly to providing those goods or services.

An entity will estimate the amount it expects to receive based on the principles for determining the transaction price (see above), except that the guidance on constraining estimates of variable consideration should not be applied. That is, an entity will use the unconstrained transaction price, which includes estimated variable consideration, for the impairment test. While unconstrained, this amount must be reduced to reflect the customer's credit risk.

Costs to fulfill a contract

Contract fulfillment costs will be recognized as an asset when the costs: (1) relate directly to a contract or to an anticipated contract that the entity can specifically identify, (2) generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future and (3) are expected to be recovered.

Generally, contract fulfillment costs incurred by asset managers (e.g., salaries paid to employees) will not meet the second criterion above because they will not generate or enhance resources of the entity that will be used to satisfy performance obligations in the future. The standard also states that costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e., costs that relate to past performance) should be expensed as incurred.

How we see it

The accounting for contract costs under the standard may change current practice for some entities. A key part of this analysis will be properly identifying the customer. Certain costs may need to be capitalized, amortized and reviewed regularly for impairment. This will require additional recordkeeping.

We expect that asset managers generally will expense many costs to fulfill a contract as they are incurred. Managers will capitalize these costs only if they expect to recover the costs and the costs generate or enhance resources that will be used in satisfying performance obligations in the future.

As discussed later in this publication, the FASB retained industry-specific guidance for certain distribution costs, which will continue to be capitalized.

Considerations for mutual fund asset managers

Combining contracts

A mutual fund often enters into multiple service contracts for advisory, distribution and shareholder service, transfer agency and custodian services, among others. In many cases, mutual funds enter into these contracts at the same time, and the service providers may be controlled by a common parent.

While the specific facts and circumstances need to be evaluated to determine whether the contracts should be combined, it is likely that the individual, separate contracts would not be combined because:

- There are different commercial objectives for each service contract.
- There is generally no pricing interdependence between the contracts.
- The contracts contain separate performance obligations.

For example, we generally would not expect an advisory contract and an underwriting (i.e., distribution) contract with the same mutual fund to be combined even though the underwriter is an affiliate of the adviser. As described previously, the adviser contracts primarily to supervise and manage the fund's assets, including handling portfolio transactions. In contrast, in a distribution agreement, the mutual fund contracts with a principal distributor that distributes the shares to the public directly or indirectly through other broker-dealers or financial intermediaries. As such, there are different commercial objectives for each service contract, even though the transaction price of both contracts may be based on NAV.

Advisory, custodian and administrative services

Advisory, custodian and administrative services are often provided pursuant to separate, one-year contracts, and the fees are often based on a percentage of NAV. In general, the revenue recognition considerations for each of these services are similar to those outlined previously for management services provided to a hedge fund.

That is, an entity may determine that each contract represents a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Because the consideration in the contract is based on a percentage of NAV, it is considered variable consideration. The variable consideration is included in the transaction price (once it is probable that it won't be reversed) and is allocated to the distinct service periods (e.g., each quarter). Revenue is then recognized at the end of each period under a time-based measure of progress (i.e., an output method). As a result, revenue recognition under the standard for these services may generally be consistent with current practice.

Transfer agency service

While the terms of transfer agent contracts vary, the provider generally contracts to maintain shareholder account records for the fund, handle certain communications between shareholders and the fund and pay certain dividends and distributions. The transfer agent often receives a monthly fee based on NAV or the number of shareholder accounts it maintains. Under the new standard, revenue will generally be recognized when the services are performed, which is consistent with current practice.

The revenue recognition for distribution fees will depend on whether the fund or the investor is the customer.

Distribution and shareholder services

Mutual funds typically enter into one contract (i.e., a distribution agreement) with a distributor to market and sell (collectively, distribute) shares and to provide shareholder services (e.g., investor services for the shareholder). The distributor, in turn, often enters into agreements with broker-dealers who sell the shares to the public.

Funds typically offer multiple classes of shares, each of which has its own terms for the payment of distribution costs and related shareholder services. Front-end load shares generally charge a sales load at the time of purchase, which is a percentage of the sales or offering price. They may also have a 12b-1 fee or an ongoing shareholder service fee that is based on NAV. Other shares have no front-end load but instead require payment of some combination of a higher 12b-1 fee and a contingent deferred sales load, which is paid if fund shares are redeemed before a stated number of years.

While the distributor is required to market the fund shares, such marketing activities may not be viewed as distinct and thus would not constitute a separate performance obligation from the selling of the shares because the entity's promise to transfer marketing services to the fund is not separately identifiable from other promises (i.e., selling of the shares) in the contract. That is, the marketing activities are undertaken to fulfill the promised service to sell shares, and the agreement generally does not specify the extent of marketing activities required to be performed.

However, distribution and shareholder services are likely distinct from each other and thus would represent separate performance obligations because the fund can benefit from either service independently and the services are separately identifiable in the contract. In these circumstances, each of these performance obligations (i.e., distribution and shareholder services) is a separate series of distinct services that are substantially the same and that have the same pattern of transfer to the customer.

Assuming the fund is considered to be the customer, the transaction price should be estimated (and as it is variable consideration, it is subject to the constraint) and allocated, if certain criteria are met, to (1) one or more (but not all) performance obligations in the contract or (2) one or more (but not all) distinct goods or services that form part of a single performance obligation.

Assuming the criteria to allocate variable consideration to specific services that form part of a single performance obligation are met, the entity will likely allocate the fees received (either ongoing fees or a sales load) to the distinct services within each of the two performance obligations provided during the service period (similar to how management fees are allocated as discussed above) because the fees relate specifically to the entity's efforts to transfer the services for that period, which are distinct from the services provided in other periods. This may result in the recognition of revenue under the new standard in the same pattern as current practice.

Distribution costs paid by distributors

Distributors of mutual funds often use sub-distributors to distribute a mutual fund's shares. Sub-distributors are often paid by the distributor upon the sale of a share, including shares that do not have a front-end sales charge (on which the distributor will earn future 12b-1 fees). To avoid mismatches between revenue and expenses, mutual fund distributors currently[2] defer and amortize incremental direct costs associated with the selling of the fund shares, including commissions paid to a sub-distributor. The new standard does not affect the guidance to account for these costs.

Disclosures

The new standard requires a comprehensive set of disclosures. These disclosures include disaggregation of revenue, information about contract asset and liability balances, information about an entity's performance obligations and information about significant judgments made in applying the revenue model. Disclosures about assets recognized from the costs to obtain or fulfill a contract are also required.

Disaggregation of revenues

The disclosure requirements begin with revenue disaggregated into categories to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. While the standard does not specify how revenue should be disaggregated, an entity should consider how it disaggregates revenue in other communications (e.g., press releases, other public filings) when determining which categories are most relevant and useful.

An entity does not have to duplicate disclosures required by another standard. For example, an entity that provides disaggregated revenue disclosures as part of its segment disclosures does not have to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors and are presented on a basis consistent with US GAAP. However, if separate disaggregated revenue disclosures are provided, the new standard requires an entity to explain the relationship between the disaggregated revenue information and the segment information.

How we see it

Many asset managers currently provide disaggregated revenue disclosures as part of their segment disclosures. However, many of these revenue amounts are presented based on non-GAAP measures, so separate revenue disclosures may still be required.

Contract balances

To help users of the financial statements understand the relationship between the revenue recognized and changes in the overall balances of an entity's total contract assets (e.g., asset for performance obligations that have been performed but an entity does not have the right to invoice) and contract liabilities (e.g., deferred revenue) during a particular reporting period, disclosure is required of the opening and closing balances, revenue recognized in the reporting period that was previously included in the contract liability balance and revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (e.g., changes in transaction price).

An entity is also required to disclose how the timing of satisfaction of its performance obligations relates to the typical timing of payment and the effect that those factors have on the contract asset and the contract liability balances. In addition, an entity should explain any other significant changes in the contract asset or contract liability balances (e.g., impairment).

Performance obligations

To help users of financial statements analyze the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, separate disclosure of information about the performance obligations in contracts and additional information about an entity's remaining performance obligations is required. For example, a public entity is required to disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when it expects to recognize the amount(s) in its interim and annual financial statements.

Significant judgments

The guidance also requires specific disclosure of significant accounting estimates and judgments made in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied. These requirements exceed those in today's general guidance on significant accounting estimates.

How we see it

Entities may need to expend extra effort when initially preparing the required disclosures for their interim and annual financial statements. For example, entities operating in multiple segments may find it challenging to gather the data needed to provide the disclosures. Entities may want to focus on the new disclosure requirements when developing their implementation plans.

Transition and effective date

The new standard is effective for public entities[3] 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.

Under a full retrospective approach, entities will apply the standard to each period presented in the financial statements in accordance with the accounting changes guidance in ASC 250, subject to certain practical expedients created to provide relief. This means entities will have to apply the new guidance as if it had been in effect since the inception of all its contracts with customers presented in the financial statements.

Next steps

Asset managers should begin considering the new standard and evaluate how it will affect their specific revenue recognition policies and practices. Even if the accounting for revenue is not expected to change significantly, changes to information systems or internal controls over financial reporting will likely be needed to apply the new standard.

Certain other effects of the revenue standard may not be as apparent. For example, an entity will need to adjust deferred tax balances for revenue that has or will create temporary differences in the future.

Entities should monitor the discussions of the Boards, SEC staff, TRG and the AICPA's asset management revenue recognition industry working group.

Public entities should consider their communication plans with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff expects entities' disclosures to evolve in each reporting period as more information becomes available.

Endnotes:

[1] ASC 605-20-S99 (formerly EITF D-96, *Accounting for Management Fees Based on a Formula)*

[2] ASC 940-605-25-4 (formerly EITF 85-24, *Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge),* which the revenue Accounting Standards Update (ASU) moved to ASC 940-720-25-1 and now directs readers to the content in ASC 946-720.

[3] The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. 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.