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Technical Line

FASB — final guidance

The new revenue recognition standard — brokers and dealers in securities

In this issue:

What you need to know

- The new standard is more principles-based than current revenue guidance and will require broker-dealers to exercise more judgment.
- Broker-dealers may need to recognize selling commissions on the settlement date instead of the trade date, as is currently required under US GAAP.
- Certain wealth and asset management performance-based fees may be recognized later than they are today.
- The new standard significantly increases the volume of required disclosures in entities' interim and annual financial statements.
- The new standard is effective for all registered broker-dealers for fiscal years beginning after 15 December 2016 and for interim periods therein.

Overview

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

Building a better working world

The effect of the new standard on the revenue recognition practices of a broker-dealer will vary, based on the nature of its major business activities. For many types of fees earned by broker-dealers, the new standard may not significantly affect the timing of revenue recognition; however, implementation efforts are in the early stages, and entities will need to apply the principles of the standard to their contracts to determine the effects.

Entities with wealth and asset management arrangements that include performance-based fees may recognize revenue later than they do today. In addition, some believe the standard will require broker-dealers to recognize trade commissions on the settlement date, rather than trade date, as is required by today's US GAAP.

This publication discusses how the revenue recognition standard will affect broker-dealers. It provides an overview of the new revenue recognition model and highlights key considerations for broker-dealers. This publication also discusses other issues broker-dealers will face when implementing the new standard. This publication supplements our Technical Line, *A closer look at the new revenue recognition standard* *(SCORE No. BB2771)*, and should be read in conjunction with it.

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

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

There are many kinds of broker-dealers providing a variety of services and in varying capacities. The arrangements discussed in this publication and the related accounting implications are not intended to be all inclusive.

Summary of the new model

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

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

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

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.

On both an interim and annual basis, an entity will generally have to provide more disclosures than it does today and include qualitative and quantitative information about its contracts with customers, significant judgments made (and changes in those judgments) and contract assets recognized from costs to obtain or fulfill a contract. On an interim basis, US GAAP will require more disclosures than will be required under IFRS.

Transition and effective date

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

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

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

How we see it

The public entity effective date applies to public business entities, which include entities whose financial statements are furnished or filed with the Securities and Exchange Commission (SEC). As a result, all US registered broker-dealers with calendar year-ends will be required to adopt the standard in 2017.

Broker-dealers also will have to make public entity disclosures that are more extensive than those for nonpublic entities.

Scope

The standard will apply to all contracts with customers to provide goods or services in the ordinary course of business, unless they are in the scope of other US GAAP (e.g., financial instruments). Some common services provided by broker-dealers that are in the scope of the standard include:

- Advisory services for public and corporate finance activities (e.g., merger-and-acquisition and financial restructuring)
- Trade execution services for customers' purchases and sales of securities
- Custody and administrative services related to securities owned by customers

- Soft-dollar arrangements
- Securities underwriting
- Wealth and asset management services

Because financial instruments are outside the scope of the revenue standard, the accounting for a broker-dealer's proprietary trading operations and any lending activities, including securities lending and repurchase agreements, will not be in the scope of the standard. The accounting for interest and dividend income on financial instruments owned or related to repurchase agreements and securities lending activities is also outside the scope of the standard.

However, the new standard provides guidance for arrangements partially within the scope of the revenue standard and partially in the scope of other standards. In those instances, an entity will first apply the separation and measurement guidance of other topics, if any. Then it will apply the separation and measurement guidance in the revenue standard to any portion of the contract not accounted for under another topic. For example, a customer contract that provides trade execution services and a line of credit that allows the customer to buy securities on margin is partially in the scope of the standard (i.e., the portion related to trade execution) and partially in the scope of other standards (i.e., the accounting for the line of credit and any related borrowings would be subject to Accounting Standards Codification (ASC) 310, *Receivables*).

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

The principles underlying each of the model's five steps are discussed in the following sections and are illustrated using a hypothetical arrangement for advisory services. Considerations for other common broker-dealer services are discussed in subsequent sections.

The following summarizes key terms of the hypothetical arrangement.

Illustration 1 — Hypothetical scenario assumptions
A broker-dealer (BD) has an existing customer for which it has provided trade execution services for the last two years. BD enters into a contract to advise the same customer about selling one of its foreign subsidiaries. The contract is for one year, unless a sale of the subsidiary occurs prior to the end of the year. BD is entitled to an up-front retainer fee of $200,000 (nonrefundable). BD is also entitled to a success fee of 2.0% of gross proceeds received if and when the subsidiary is sold. All other customary terms and conditions, as well as the rights and obligations of the contracting parties, are outlined in the contract.

Identify the contract with a customer

To apply the model, an entity must first identify the contract(s) and customer(s). A contract with a customer that creates enforceable rights and obligations and meets certain criteria falls within the scope of the guidance. These criteria include approval of the contract by all parties and their commitment to perform their respective obligations, the ability to identify each party's rights regarding goods and services to be transferred and the associated payment terms, and whether the contract has commercial substance.

Such contracts may be written, oral or implied by the entity's customary business practice, but must be enforceable by law. For example, an entity's past business practices may influence its determination of when an arrangement meets the definition of a contract with a customer.

Combining contracts

The standard requires two or more contracts entered into at or near the same time with the same customer (or related parties) to be combined and accounted for as a single contract when any of the following criteria are met: (1) the contracts are negotiated as a package with a single commercial objective, (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contract or (3) the goods or services promised in the contracts (or some goods or services promised in each of 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 advisory contract should not be combined with the existing trade execution contract with the customer because the contracts were not entered into at or near the same time.

Identify the performance obligations in the contract

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

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

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct).
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

The standard includes certain factors to evaluate whether the promise to transfer the good or service is separately identifiable. For example, a good or service that is highly dependent on, or highly interrelated with, other goods or services promised in the contract is generally not separately identifiable. Typically, a good or service is not separately identifiable from other promises in the contract when an entity uses the good or service as an input into a single process or project that is the output of the contract.

Entities will need to consider each contract's specific terms to identify the promised goods and services. The Boards noted that in many cases all of the promised goods or services in a contract might be identified explicitly in that contract. However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices. The standard indicates that when an entity identifies the promises in a contract, it should consider whether the customer has a valid expectation that the entity will provide a good or service. The Boards clarified that while the contract must be legally enforceable to be within the scope of the guidance, the performance obligations within the arrangement can be based on valid expectations of the customer, even if the promise is not legally enforceable.

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 by broker-dealers are provided continuously over the contract period, so the service contract will generally represent a single performance obligation with a number of distinct service periods (e.g., days, months, years).

Illustration 3 — Identify the performance obligations in the contract

Based on the facts in the previous illustrations, as it relates to the advisory contract, there is a single performance obligation that is a series of distinct goods or services (advisory activities) that are substantially the same and have the same pattern of transfer (i.e., they are performed daily).

BD would need to evaluate whether there are any other goods or services that are promised in the contract and determine whether they are distinct. For purposes of this illustration, there are no distinct goods or services aside from the advisory activities.

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

How we see it

Identifying implicit promised goods and services may be challenging. Broker-dealers may provide certain services as customary business practices (for which they may or may not charge a fee), even though these items may not be explicit in the contract or legally enforceable. However, these services may be considered distinct performance obligations under the new standard.

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 amounts collected on behalf of third parties. The transaction price includes an estimate of any variable consideration, the effect of a significant financing component (i.e., the time value of money), the fair value of any noncash consideration and the effect of any consideration payable to the customer.

For contracts in which the promised consideration is variable (e.g., a contract with a performance bonus), an entity will need to estimate the amount of consideration to which it expects to be entitled. The amount of variable consideration to be included in the transaction price (subject to a constraint described below) will be estimated using either an expected value method (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. That is, the method selected is not meant to be a "free choice." Rather, an entity needs to consider which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.

When estimating variable consideration, broker-dealers should consider all information (historical, current and forecast) that is reasonably available. Further, when using the expected value method, a reasonable number of possible outcomes should be identified (i.e., an entity is not required to consider all possible outcomes). 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 limited to the amount for which it is probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. This determination includes considering both the likelihood and the magnitude of a revenue reversal. Further, the constraint on variable consideration focuses on reversals that would be significant when compared to cumulative 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 that could increase the likelihood or the magnitude of a revenue reversal. One of these factors is when the amount of variable consideration is highly susceptible to factors outside the entity's influence (e.g., actions of third parties, volatility in the market). Other factors include when the entity's experience with similar contracts is limited or has little predictive value, and the contract has a large number and broad range of possible consideration amounts. The presence of these factors does not necessarily mean that variable consideration can't be recognized (hence the Boards' use of the term "factors" rather than "criteria"), but entities should carefully evaluate the circumstances when such factors exist and have robust documentation supporting any conclusions that such amounts are not constrained.

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

Illustration 4 — Determine the transaction price

Based on the facts in the advisory contract illustration, the transaction price includes both fixed and variable consideration. The retainer is a fixed amount, whereas the success fee is variable consideration based on the gross proceeds of a sale of the subsidiary, if any. BD would estimate the variable consideration likely using the expected value method because that is the method that best predicts the consideration to which it will be entitled, due to the range of possible consideration amounts. The estimated variable consideration is reassessed at each reporting date.

Because the estimated amount of the success fee is highly susceptible to factors outside the entity's influence, BD is unable to assert at contract inception that it is probable that a significant revenue reversal will not occur for any portion of the variable consideration. Therefore, the success fee is not included in the transaction price at contract inception, nor at any future reporting date, until the uncertainty related to the variable consideration is resolved. At contract inception, the entity determines that its transaction price is $200,000.

Allocate the transaction price to the performance obligations in the contract

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

Under the standard, the standalone selling price represents the price for which an entity will sell a good or service underlying each performance obligation on a standalone basis at contract inception. The model indicates 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 to allocate 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 or one or more (but not all) distinct goods or services that form part of a single performance obligation, if certain criteria are met.

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 the performance obligation and (2) allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the objective to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.

For services performed over time, the variable consideration may be allocated to distinct services (e.g., months or quarters of advisory services) that form part of a single performance obligation instead of being spread over the entire performance obligation (e.g., contract period of one year of advisory services) if the two criteria are met.

Illustration 5 — Allocate the transaction price to the performance obligations in the contract

The advisory contract in the previous illustration has a single performance obligation (advisory activities), which obviates the need to allocate the transaction price based on standalone selling prices.

In this illustration, the advisory services represent a series of distinct services (i.e., daily advisory services) that form part of a single performance obligation. The standard requires entities to allocate the variable consideration (i.e., the success fee), once it is probable that a significant revenue reversal will not occur, to the distinct services if (1) the terms of the payment relate specifically to the entity's efforts to satisfy the distinct services and (2) the allocation is in an amount that represents the amount of consideration to which the entity expects to be entitled for performing those services.

In this illustration, the success fee will not be allocated to the distinct services in the advisory contract because the success fee relates to advisory services that will be provided over the entire contract, not to a specific period prior to the sale.

When the success fee is no longer constrained (e.g., a deal is reached in principle but is subject to regulatory approval that is probable of occurring), the BD would have to allocate the success fee over the entire service period.

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.

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

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (e.g., asset management services, custody services).
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g., a contract to develop a trade execution system on the customer's network).
- 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 (e.g., a contract to develop a personalized capital restructuring plan).

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

When a performance obligation is satisfied over time, the standard requires an entity to select a single method to measure progress for each performance obligation that best depicts the entity's performance in transferring control of the goods or services to the customer. That method should be applied consistently to similar performance obligations and in similar circumstances. The standard provides that revenue on arrangements involving the transfer of goods or services over time may be recognized by applying either an input method or an output method.

Using an input method, revenue is recognized based on the ratio of efforts already expended relative to the total efforts expected to be expended. Using an output method, revenue is recognized based on direct measurements of the value to the customer of the goods or services transferred to date. For example, these direct measurements include milestones reached and time elapsed.

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

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

Based on facts in the advisory contract illustrations, BD recognizes the $200,000 fixed amount (i.e., the retainer fee), and any portion of the variable consideration (i.e., the success fee) when it is probable that a significant revenue reversal will not occur, over the one-year contract period (i.e., based on the time elapsed in proportion to the contract period), using a cumulative catch-up approach if necessary.

If a sale of the subsidiary occurs before the end of the one-year contract period, BD would recognize the unrecognized portion of the $200,000 retainer fee and the success fee on the date of the closing of the subsidiary's sale.

If there was no explicit contract period, BD would likely need to estimate the period of service and recognize the revenue over that estimated period.

Contract costs

The standard also provides guidance on accounting for an entity's costs incurred in obtaining and fulfilling a contract (or, in some instances, an anticipated contract) to provide goods and services to customers.

Costs to obtain a contract

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

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

For broker-dealers, sales commissions paid to employees that are directly related to obtaining a customer contract may require capitalization if the contract period is greater than 12 months. This may result in a change in practice for broker-dealers that currently expense these direct costs as incurred.

In contrast, some bonuses and other compensation arrangements that are based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not incremental costs to obtaining a contract. Due diligence and other legal expenses incurred before a contract is obtained also likely will not qualify as incremental costs to be capitalized because they would be incurred even if the contract was not obtained.

Costs to fulfill a contract

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

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

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

Some costs incurred by broker-dealers while providing advisory services (e.g., travel, meals) and other general fulfillment costs (e.g., salaries paid to employees) do not generate or enhance resources that will be used in satisfying performance obligations in the future and should be expensed as incurred. In contrast, certain costs associated with securities underwriting activities, including research and legal expenses incurred in advance of fulfilling future performance obligations, will be capitalized if they meet the criteria described above.

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) are expensed as incurred.

Illustration 7 — Contract costs

BD wins a competitive bid to provide advisory services to a new customer. BD incurred the following costs to obtain the advisory services contract:

External legal fees for due diligence	$ 15,000
Travel costs to deliver proposal	25,000
Referral fee paid to third party	10,000
Total costs incurred	$ 50,000

BD recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the referral fee paid to a third party because (1) the referral fee would have been paid only if the contract was won and (2) the entity expects to recover those costs through future fees for the advisory services.

BD also pays discretionary annual bonuses to sales supervisors based on overall profitability of the entity and individual performance evaluations. BD does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are not directly attributable to identifiable contracts.

BD observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, BD does not recognize an asset for the external legal fees and travel costs.

Costs for which an asset is not recognized are expensed when incurred, unless they are within the scope of another ASC topic, in which case the guidance in that ASC topic applies.

The FASB retained industry-specific guidance for distribution costs and underwriting expenses, which will continue to be capitalized.

How we see it

The requirement to capitalize certain costs of obtaining a contract with a customer could change practice for some entities. Commissions paid for obtaining a new contract or customer, for example, may need to be capitalized, amortized and reviewed regularly for impairment. This would require additional recordkeeping.

The FASB retained industry-specific guidance that requires underwriting expenses to be capitalized.[2] The FASB also retained industry-specific guidance for costs associated with mutual fund distribution services,[3] which will continue to be capitalized, and costs for soft-dollar arrangements,[4] which will be deferred or accrued based on the trade execution activity for the period.

For all other costs of fulfilling a contract that are not covered by specific industry guidance, broker-dealers generally will continue to expense costs to fulfill a contract as they are incurred because they generally do not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

Application to other common service arrangements

Trade execution and custody services

A broker-dealer may buy and sell securities on behalf of its customers. In return for such services, the broker-dealer charges a commission each time a customer enters into a buy or sell transaction.

Broker-dealers may also provide their customers with custody services, including safekeeping of purchased securities, processing of any dividend and interest payments, and certain recordkeeping functions such as processing and mailing customer account statements and annual tax forms such as IRS Form 1099.

Identify the contract with a customer

Typically, a customer will sign one contract with a broker-dealer that governs the terms and conditions for both trade execution and custody services, which may be terminated at will by either the customer or broker-dealer.

Identify the performance obligations in the contract

Trade commissions will be considered variable consideration because the consideration is contingent upon the number of trades executed.

A broker-dealer needs to evaluate whether the two promised services (the custody service and the trade execution services) are distinct. Generally, both of these performance obligations provide a benefit to the customer either individually or together with other resources that are readily available to the customer (i.e., a customer can benefit from custody services or trade execution services on their own), and they are promises that are separately identifiable from each other (i.e., the services are distinct within the context of the contract).

The trade execution service is performed each time a trade is executed. The trade execution services would not be considered a series of distinct services because the trade execution services do not have the same pattern of transfer (because a customer's trade activity typically varies by day), so each trade execution service likely will be considered a distinct performance obligation.

Conversely, custody services are provided continuously over the contract, so they generally will represent a single performance obligation comprised of a series of distinct services (e.g., daily periods of service because most contracts may be terminated for any reason by either the customer or broker-dealer).

How we see it

Identifying implicit promised goods and services in a contract may be challenging. Broker-dealers may provide investment research services, among others, as customary business practices even though these items may not be explicit in the contract or legally enforceable. In some instances, broker-dealers may not separately charge some of their customers for these services. However, these services may be considered separate performance obligations under the new standard.

Determine the transaction price

Typically, the transaction price for the contract that covers both trade execution and custody services is based solely on the commission rate quoted by the broker-dealer for trade execution. However, a separate fee may be charged for custody services in arrangements that require the processing and handling of physical certificates or legal documents or accounts that have limited or no activity.

The trade commissions (or the trade commission portion of the fee if custody services are charged separately) will be considered variable consideration because the consideration for the entire contract depends on the number of trades executed.

The amount of variable consideration to be included in the transaction price will likely be estimated using an expected value method (sum of probability-weighted amounts) because there will be a range of possible outcomes. However, that price will be limited to the amount for which it is probable that a significant reversal will not occur when the uncertainty is resolved. Generally, a broker-dealer will not be able to assert that it is probable that revenue will not be reversed because the consideration in these contracts is highly susceptible to factors outside the entity's influence (i.e., a customer submitting trade orders). Thus, estimated commission fees for the remaining expected contract period will generally not be included in the transaction price until trades are submitted. Once trades occur, the constraint will be overcome because the consideration is known and is not subject to significant revenue reversal, and the amount associated with the trades that have occurred will be included in the transaction price.

Allocate the transaction price to the performance obligations in the contract

As discussed above, the standard provides specific guidance for allocating variable consideration to one or more (but not all) performance obligations and to one or more (but not all) distinct goods or services that form part of a single performance obligation.

Variable consideration is allocated entirely to one or more, but not all, performance obligations or to one or more, but not all, distinct goods or services that form part of a single performance obligation if (1) the terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation and (2) allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the objective to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services.

The variable consideration for which it is probable that a significant revenue reversal will not occur (i.e., the consideration related to executed trades) may be allocated to the distinct periods (i.e., one day of custody services) and distinct performance obligations (i.e., the number of trades executed during the day) because it relates specifically to the entity's efforts to satisfy the performance obligations, 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 performing the services. That is, the trade commissions for the trades that have already occurred are the consideration the broker-dealer is entitled to for the trade execution and custody services it has already provided. The amount the broker-dealer expects to be entitled to for the performance of custody services in the future (even if no trades are executed on those dates) is the amount it will receive from future trade commissions.

The new standard requires entities to allocate variable consideration to the contract's performance obligations in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. In the case of combined trade execution/custody services, there generally is no need to allocate the consideration between the two performance obligations because both are satisfied on the same day (as discussed below), unless an entity is required to separately present or disclose the trade execution and custody services in its financial statements or accompanying notes.

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

Trade execution may be viewed as being satisfied at a point in time, so the broker-dealer will need to determine the point in time at which the customer obtains control (i.e., obtains the benefits from that service). The standard provides certain criteria to determine when control is transferred, including when the entity has a present right to payment. When control is transferred the portion of the transaction price allocated to the trade execution services will be recognized as revenue.

The custody services are generally satisfied over time because the customer simultaneously receives and consumes the benefits provided by the broker-dealer as the broker-dealer performs the services. The broker-dealer will likely use time elapsed (an output method) to measure progress in performing the custody services and recognize the portion of the transaction price allocated to the custody services as revenue as the services are provided.

Trade date versus settlement date

It is unclear whether broker-dealers will be required to change when they recognize commission income from trade execution services (i.e., transactions executed by broker-dealers as agents for customers[5]). Under the standard, control refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Services are assets, even if only momentarily, when they are received and used.

One view is that a broker-dealer does not fulfill its obligation (i.e., transfer control of the service) to the customer until the trade is settled because the broker-dealer has a contractual responsibility to the customer to deliver the security purchased (or to deliver the cash received from the sale of the security). Under this view, broker-dealers would recognize the allocated transaction price on the settlement date.

A second view is that the asset being transferred to the customer is the trade execution service (i.e., filling an order), not the delivery of the security that's being purchased by the customer or the proceeds from a sale. That is, the benefit of the service transfers to the customer on the trade date because that is the date when the broker-dealer completes the order and enters into the contract on behalf of the customer. The trade date is also the date when the customer assumes the risks and rewards of further changes in the value of the underlying financial instrument. Under this view, the broker-dealer would recognize commission income on the date of the trade order.

If the customer or the other counterparty does not remit payment/securities, the broker-dealer is required to remedy the failure to perform by either party. Some may view this remedy as part of the performance obligation, so revenue would not be recognized until the settlement date. However, this remedy may be similar to a warranty, which is specifically addressed in the new standard. The standard states that warranties may provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications, which is consistent with the remedy a broker-dealer would provide. The guidance further states that a warranty is a distinct service only if the customer has the option to purchase the warranty separately or the warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. As neither criterion is met, the obligation to remedy a failure to perform would not affect the timing of revenue recognition if considered an assurance warranty.

How we see it

If transfer of control is determined to occur on the settlement date, the change in the timing of revenue recognition would be a significant change in practice for the industry. Although the time between the trade date and the settlement date is generally short (e.g., three days for purchases and sales of equity securities traded on US stock exchanges), broker-dealers may need to make significant changes to systems to implement this change.

Soft-dollar arrangements

The ASC Master Glossary describes soft-dollar arrangements as arrangements in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from that customer. These arrangements generate commission income for the broker-dealer. The value of the research to be provided is typically based on a percentage of commission income. Soft-dollar customers are typically institutional investors or money managers. Soft-dollar research may be generated either internally by the broker-dealer or purchased by the broker-dealer from a third party.

Some broker-dealers and money managers have used "soft dollars" to cover expenses not associated with research. These types of transactions are governed by Section 28(e) of the Securities Exchange Act of 1934, which allows the paying of a brokerage commission if the manager determines in good faith that the commission is reasonable in relation to the value of the brokerage and research services provided.

Identify the contract with a customer

Soft-dollar arrangements may either be separately negotiated or negotiated as part of a contract for trade execution services. If separately negotiated, soft-dollar arrangements would meet the definition of a contract only if, among other things, they are considered legally enforceable. Even if the soft-dollar arrangement is included in a separate contract, it may meet the contract combination criteria if it is entered into at or near the same time and the price of the contracts are interdependent. An entity also may need to consider the contract modification guidance if the soft-dollar arrangement affects the transaction price of a related trade execution contract. The following analysis assumes that the soft-dollar arrangement is included in (or combined with) the trade execution contract.

Identify the performance obligations in the contract

If the broker-dealer satisfies its soft-dollar obligations by providing internally generated investment research, this service will likely be considered a separate performance obligation from trade execution because the customer can benefit from the research services on its own, and they are separately identifiable in the contract.

However, if the broker-dealer pays the customer's third-party service providers for investment research or other permissible services (e.g., subscription services for computer systems that allow users to monitor and analyze real-time financial market data and place trades on the electronic trading platform) to fulfill the soft-dollar arrangement, the payment will likely be considered consideration payable to the customer (discussed further below). That is, it would not be a separate performance obligation.

Determine the transaction price

The transaction price for soft-dollar arrangements is typically based solely on the commissions charged by the broker-dealer for the related trade execution services.

These trade commissions would be considered variable consideration because the consideration is contingent upon the number of trades executed. However, that price will be limited to the amount for which it is probable that a significant revenue reversal will not occur when the uncertainty is resolved. Estimated commission fees for the remaining expected contract period will generally not be included in the transaction price until trade orders are submitted. Once trades occur, the constraint is overcome, and the amount is included in the transaction price.

If the broker-dealer pays for the customer's investment research or other investment related services that are provided by third parties, the soft-dollar arrangement would be akin to consideration payable to the customer. Under the new standard, consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer. An entity will account for consideration payable to a customer as a reduction of the transaction price and therefore a reduction of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the broker-dealer.

In the case of a soft-dollar arrangement, the consideration paid or payable generally is not in exchange for a distinct good or service, so the amount of these payments to the customer likely will reduce the overall transaction price and the associated revenue.

Allocate the transaction price to the performance obligations in the contract

Once the performance obligations have been identified and the transaction price has been determined, an entity will allocate the transaction price to the performance obligations generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). In a typical soft-dollar arrangement, the separate performance obligations may include investment research services (when provided by the broker-dealer), trade execution and custody services.

How we see it

In the case of custody and investment research services, standalone selling prices may not be readily observable. In these situations, an entity will need to estimate the amount for which it would sell each good or service on a standalone basis, which will require significant judgment based on the specific facts and circumstances.

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

An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation.

The performance obligation associated with the research services may be satisfied at a point in time or over time, depending on the facts and circumstances of the arrangement. For example, a customer may be entitled to a certain number of calls with specific industry analysts (i.e., a service satisfied at a point in time) or access to analyst reports over the contract period (i.e., a service satisfied over time).

Revenue will be recognized on the date that the research services are provided to the customer for those services that are determined to be satisfied at a point in time, whereas an output method (e.g., time elapsed or milestones reached) will likely be used to measure the progress of any research services determined to be satisfied over time.

In certain cases, the research services may be provided before sufficient trades are executed to generate payment to cover them. Satisfaction of performance obligations before payment is received will result in a contract asset that will be recognized until sufficient trades occur. When those trades occur, a portion of the trade commission received will reduce the contract asset. Likewise, payment received before the performance obligation is satisfied results in a contract liability (e.g., deferred revenue). This result is consistent with the industry-specific guidance[4] for soft-dollar arrangements that was retained by the FASB.

Securities underwriting

Securities underwriting refers to the process by which investment banks raise investment capital from investors on behalf of corporations and governments that are issuing securities (both equity and debt).

An underwriting agreement is a contract between a corporation or government entity issuing new securities and the lead underwriter of the syndicate. The underwriting agreement states the public offering price, the underwriting spread, the net proceeds to the issuer and the settlement date.

Separate from the underwriting agreement, a syndicate agreement is a contract between participating members of an investment banking syndicate (sometimes called a syndicate contract or purchase group agreement).

Because the lead underwriter is given the legal authority to sign the contract on behalf of the syndicate (through the syndicate agreement), all of the syndicate members are considered parties to the underwriting agreement. Generally, each syndicate member named in the underwriting agreement is severally obligated to purchase the offered securities for their own accounts (in a firm commitment) or sell the offered securities to investors (in a best-efforts arrangement).

Underwriters earn revenue from the price difference (the underwriting spread) between the price they pay the issuer of securities and the public offering price.

Identify the contract with a customer

Underwriting agreements are written contracts between the corporation or government (customer) issuing new securities and all members of the syndicate by proxy, as described above. Among other things, the agreement states the public offering price, the underwriting spread and reimbursable expenses, the net proceeds to the issuer, the settlement date and, if applicable, the overallotment option. As a result, an underwriting agreement meets the standard's contract criteria because the contract has been approved, identifies each party's rights and associated payment terms, and has commercial substance.

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.

Generally, the underwriting (sale) of securities is the only performance obligation explicit in the underwriting agreement. However, the terms of the individual underwriting arrangements should be evaluated carefully to identify any other explicit or implicit promised goods and services and to determine whether they represent separate performance obligations.

Determine the transaction price

The transaction price for the underwriting service (i.e., the underwriting spread) includes the following components:

- Management fee: Compensates the lead underwriter(s) for structuring the offering
- Selling concession: Compensates each underwriter for selling shares
- Underwriting fees: Compensates each underwriter for bearing the underwriting risk (i.e., making capital commitment)

The amount of underwriting spread that each syndicate member is entitled to varies depending on its role. Generally, the price of the securities being issued (and the resulting underwriting spread) is known on the day that the underwriting agreement is signed. As a result, the transaction price will not include variable consideration.

Allocate the transaction price to the performance obligations in the contract

Once the distinct performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price to the performance obligations, generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). As discussed above, a typical underwriting arrangement includes a single performance obligation, so no allocation of the transaction price is required.

A lead underwriter will need to determine whether it is acting as a principal or an agent for the syndicate.

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

Generally, the performance obligation associated with an underwriting agreement will be satisfied on the trade date (i.e., the date the underwriter purchases the securities from the issuer), so the fees (i.e., the applicable spread) will be recognized as revenue at that time.

Contract costs

Underwriting expenses include marketing and advertising fees, legal fees and other costs associated with setting up the syndicate group. These expenses are accumulated by the lead underwriter and are allocated to the other members of the syndicate on a pro-rata basis.

The new standard does not change today's requirement in ASC 940-340-25-3 that underwriting expenses incurred before the issuance of the securities be deferred.

Principal versus agent considerations

The standard states that when other parties are involved in providing goods or services to an entity's customer, the entity must determine whether its performance obligation is to provide the good or service itself (i.e., the entity is a principal) or to arrange for another party to provide the good or service (i.e., the entity is an agent). An entity is a principal if it controls a promised good or service before it transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if it obtains legal title only momentarily before the good or service is transferred to a customer.

The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognizes. When the entity is the principal in the arrangement, revenue is recognized based on the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognized is the net amount to which the entity is entitled to retain in return for its services as the agent. That is, the entity's fee or commission should be the net amount of consideration that the entity retains after paying the other party for the goods or services to be provided by that party.

Determining whether the lead underwriter should present underwriting revenues gross or net of amounts allocated to the other syndicate members is based on whether the lead underwriter is acting as a principal or agent. Indicators of an agency relationship are provided in ASC 606-10-55-39. These indicators, along with the relevant facts for an underwriter, are as follows:

- *Another party is primarily responsible for fulfilling the contract*. Syndicate members named in the underwriting agreement, for whom the lead underwriter is acting as a representative, are severally obligated to purchase the offered securities for their own accounts (in a firm commitment) or sell the offered securities to investors (in a best-efforts arrangement).
- *The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return*. Generally, each syndicate member is severally obligated to purchase the offered securities for their own accounts (in a firm commitment) or sell the offered securities to investors (in a best-efforts arrangement) as indicated in the underwriting agreement and registration statement.
- *The entity does not have discretion in establishing prices for the other party's goods or services, and therefore the benefit that the entity can receive from those goods or services is limited.* The lead underwriter, as manager and representative of the syndicate group, negotiates the terms and conditions of the deal economics with the issuer. However, determination of the underwriting spread is largely based on industry convention and market conditions. The syndicate agreement separately spells out how the underwriting spread will be allocated among the syndicate members based on roles and responsibilities.
- *The entity's consideration is in the form of a commission.* The underwriting spread is allocated among the syndicate members in proportion to their underwriting commitment taking into consideration specific roles and responsibilities. For example, only the lead underwriter is entitled to the management fee component of the underwriting spread as compensation for arranging and managing the transaction.
- *The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.* This factor may not be met for the lead underwriter. In the US, the lead underwriter and the issuer typically exchange shares and cash on the settlement date, which is the trade date plus three business days. The lead underwriter is exposed to settlement risk if a syndicate member defaults between the trade date and settlement date.

No single indicator listed above is determinative of the relationship between the lead underwriter and the other syndicate members.

How we see it

Broker-dealers should consider the effect of any change to gross versus net revenue presentation on their compensation arrangements that are based on GAAP revenues. Many of these arrangements were intended to compensate employees based on net revenues, so the terms of the arrangement may need to be reconsidered if an entity presents revenues on a gross basis.

Wealth and asset management services

Certain broker-dealers provide wealth and asset management services to retail and institutional clients. These services include providing investors with investment recommendations, portfolio diversification and rebalancing. 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. That could be a change for entities that currently apply SEC staff guidance in ASC 605-20-S99 and 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.

See our separate Technical Line, *The new revenue recognition standard — asset management (SCORE No. BB2796)*, for a detailed discussion of the application of the standard to asset managers.

Mutual fund distribution services

Distributors of mutual funds often use sub-distributors (e.g., other broker-dealers) 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[6] defer and amortize incremental direct costs associated with the selling of the fund shares, including commissions paid to a sub-distributor. The new standard retains the guidance to account for these costs.

Refer to our separate Technical Line, *The new revenue recognition standard — asset management*, for revenue recognition considerations related to mutual fund distribution services.

Next steps

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

All entities will need to evaluate the requirements of the new standard to determine the effects, so implementation efforts will be required even if the accounting results for revenue transactions don't change significantly or at all.

Entities also may want to monitor the discussions of the Boards, the SEC staff, the TRG and the broker-dealer industry task force formed by the AICPA to discuss interpretations and the application of the new standard to common transactions.

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

[2] ASC 940-340-25-3.

[3] ASC 940-720-25-1 and ASC 946-720-25-4, as amended by ASU 2014-09.

[4] ASC 940-20-25-3.

[5] Proprietary transactions, such as sales on securities to customers out of the broker-dealer's own inventory, are outside the scope of the new revenue standard and subject to the accounting guidance in ASC 860, *Transfers and Servicing*.

[6] 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*).