REVENUE RECOGNITION FOR ASSET MANAGERS

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1. Background and introduction

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606),* to provide a robust framework and comprehensive principles for addressing revenue recognition issues. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of ASC 606 was codified in ASC 340-40, "Other Assets and Deferred Costs – Contracts with Customers."

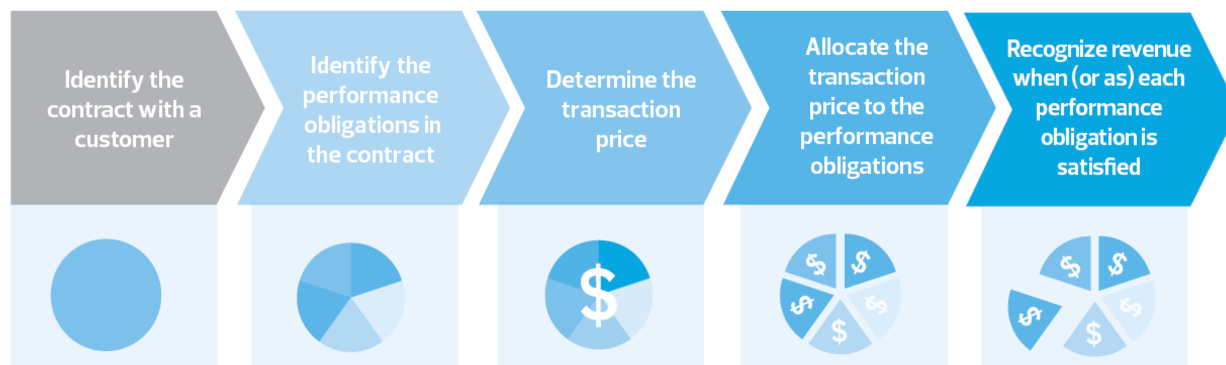
While the accounting for many of an asset manager's revenue streams is affected by ASC 606, the following are some of the revenue or income streams that are not affected by ASC 606:

- Gains and losses on the transfer and derecognition of financial instruments, which are within the scope of ASC 860, "Transfers and Servicing"
- Interest income on investments in debt instruments, which is within the scope of ASC 310, "Receivables," and ASC 835, "Interest"
- Payment-in-kind dividends and interest from investments in debt and equity securities, which are within the scope of ASC 845, "Nonmonetary Transactions"
- Fee income received from debt instruments, which is within the scope of ASC 310, "Receivables"
- Dividend income on equity investments and realized gains and losses on financial assets and liabilities, which are within the scope of ASC 320, "Investments – Debt and Equity Securities"

The American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces, including the Asset Management Revenue Recognition Task Force, to identify and provide guidance on implementation issues in specific industries. The culmination of the AICPA task forces' activities was the issuance of a final comprehensive nonauthoritative revenue recognition guide in 2019, the AICPA Audit and Accounting Guide, *Revenue Recognition* (the Revenue Recognition AAG), which provides helpful discussion and illustrative examples on how to apply the guidance in ASC 606 and ASC 340-40. This white paper discusses topics addressed in Chapter 4 of the Revenue Recognition AAG.

2. Core principle and key steps

To put the specific aspects of the revenue recognition guidance discussed in this white paper into proper context, it is important to know that the core principle included in the guidance (ASC 606-10-10-2) is to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." In addition, the guidance sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



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2.1 Step 1: Identifying the contract with a customer

A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." To account for a contract in accordance with the guidance, the following contract existence criteria must be met:

- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Commercial substance exists
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur)

These criteria are first evaluated at contract inception and, if all of the criteria are met, they only need to be reassessed if there is a significant change in circumstances. While any reassessment should not result in the reversal of any revenue already recognized, an entity should consider whether any receivables or contract assets recognized before the significant change in circumstances are impaired.

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of the contract existence criteria are not met, revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only recognized under very limited circumstances, which could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

2.2 Step 2: Identifying performance obligations in the contract

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. The first step in identifying the performance obligations in the contract is to identify all of the promises to provide goods or services in the contract. Once that step is complete, if there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and accounted for separately. The determining factor in this analysis is whether each promised good or service is distinct. A promised good or service is considered distinct if it is capable of being distinct and it is distinct within the context of the contract. A promised good or service that is considered distinct is accounted for separately as a performance obligation unless the series exception applies.

A series of distinct promised goods or services that are substantially the same should be considered a single performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of each of the goods or services otherwise being considered satisfied over time and the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services. This exception is commonly referred to as the series exception.

Refer to Section 5.2 and Section 9.2 for details on applying this guidance to contracts that include asset management fees and CDSC fees, respectively.

2.3 Step 3: Determining the transaction price

Transaction price is defined in ASC 606-10-32-2 as "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 (for example, some sales taxes)." In addition to the contract

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terms, the entity's customary business practices also should be taken into consideration in determining the transaction price.

The entity should assume that the contract will be fulfilled in accordance with its terms and customary business practices for purposes of determining the transaction price. In other words, the entity should not assume or consider cancellation, renewal or modification of the contract.

Refer to Chapter 12 for information regarding an asset manager excluding amounts collected from the customer on behalf of third parties from the transaction price, as well as other gross versus net reporting issues.

The transaction price includes or could be affected by:

- Fixed cash consideration
- Variable consideration
- Noncash consideration
- Significant financing component
- Consideration payable to the customer

Issues encountered by entities in determining the transaction price typically involve variable consideration. Variable consideration can take many forms, including performance fees or amounts based upon underlying assets managed.

An entity may not be required to estimate variable consideration when it:

- Provides a series of distinct good or services for which the variable payments relate specifically to the entity's efforts to transfer each distinct good or service within the series (see Section 8.3.2.1 5 of our revenue recognition guide)
- Is entitled to sales- or usage-based royalties and the only, or predominant, item to which the royalty relates is the license of IP (see Section 7.3.5 of our revenue recognition guide)
- Elects to apply the practical expedient that allows revenue to be recognized for the amount the entity has a right to invoice (see Section 9.3.1.1 of our revenue recognition guide)

Outside of these exceptions, an estimate of the variable consideration to which the entity expects to be entitled should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved ("variable consideration constraint").

One of the following two methods must be used to estimate the variable consideration to which the entity expects to be entitled:

- *Expected value method.* Under this method, the entity identifies a range of possible consideration amounts, assigns a probability to each identified amount in the range based on the likelihood that amount will be the final consideration amount, calculates the probability-weighted amount for each identified amount in the range and totals those probability-weighted amounts to arrive at the estimate of variable consideration to which the entity expects to be entitled.
- *Most likely amount method*. Under this method, the entity identifies a range of possible consideration amounts and then identifies the amount within that range that will most likely be the final consideration amount.

The method an entity should use depends on which method will better predict the amount of variable consideration in the particular set of facts and circumstances. One method should be used consistently when accounting for a contract's variable payment stream.

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The estimate of variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. Any changes in the estimate of variable consideration are treated the same as any other changes in the transaction price. The method used to initially estimate the variable consideration included in the transaction price also should be used when the estimate is reassessed each reporting period.

Refer to the following sections of this white paper for discussion on applying the variable consideration guidance to different types of fees earned by asset managers or distributors:

- Section 5.3: management fee revenue, excluding performance fee revenue
- Chapter 6: management fee waivers and customer expense reimbursements
- Chapter 7: incentive or performance fee revenue, excluding incentive-based capital allocations
- Chapter 8: incentive-based capital allocations
- Section 9.3: recognition of CDSC fees

2.4 Step 4: Allocating the transaction price to the performance obligations

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts or variable consideration that can be shown (by meeting certain criteria) to be related to one or more (but fewer than all) performance obligations or one or more (but fewer than all) distinct goods or services when the series exception applies.

Refer to the following sections of this white paper for discussion of applying this guidance to different types of fees earned by asset managers and distributors:

Section 5.4: management fee revenue, excluding performance fee revenue

Chapter 7: incentive or performance fee revenue, excluding incentive-based capital allocations

Chapter 8: incentive-based capital allocations

Section 9.4: recognition of CDSC fees

2.5 Step 5: Recognizing revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it. To properly assess when revenue should be recognized, an entity must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time.

Control of an asset has transferred to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits, which includes the customer being able to stop others from directing the use of the asset and receiving substantially all of the related remaining benefits. For this purpose, benefits are considered in terms of the potential cash flows the customer can obtain or save (directly or indirectly) as a result of having control of the asset.

ASC 606 provides several indicators that should be considered in assessing whether control of an asset has transferred to the customer, including indicators focused on the customer’s obligation to pay, customer acceptance and the transfer of legal title, physical possession and the significant risks and rewards of ownership.

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As indicated earlier, an entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time. If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the entity's performance at the same time as the customer receives those benefits and the entity performs and creates those benefits.
- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the entity's performance.
- *No alternative use and an enforceable right to payment for performance to date.* A performance obligation is satisfied over time if the asset created by the entity's performance does not have an alternative use to the entity upon its completion and the entity's right to payment for its performance to date is enforceable.

If the performance obligation is considered satisfied over time because one of the criteria is met, the related revenue is recognized over time. The objective of the method selected should be to measure the progress made in transferring control of the underlying goods or services to the customer. The method selected should be applied consistently to similar performance obligations in similar circumstances.

If a performance obligation does not meet any of these criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time that the customer obtains control over the underlying good or service.

Refer to Section 5.5 and Section 9.5 for discussion on applying this guidance to management fee revenue, excluding performance fee revenue, and CDSC fees, respectively.

3. Contract costs

ASC 340-40 addresses the circumstances under which the following costs should be capitalized:

- *Costs to fulfill a contract.* If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Costs to fulfill a contract for which there is no other applicable guidance should be capitalized when all of the following criteria are met:
  - The costs incurred by the entity are directly related to a specific contract or specific anticipated contract (e.g., design costs of an asset for a specific contract that is pending approval).
  - The costs incurred by the entity generate or enhance resources that will be used in the future to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not performance obligations in and of themselves, but they do contribute to the satisfaction of performance obligations).
  - The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the contract and expected renewals will cover the costs).

  If these fulfillment cost capitalization criteria are met, the fulfillment costs must be capitalized. In other words, there is no option to expense fulfillment costs for which these criteria are met.
- *Costs to obtain a contract.* The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained. These incremental costs should be capitalized if the entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an entity may elect a

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practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period would otherwise be one year or less.

Costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

Capitalized contract costs should be amortized in a manner that is consistent with how and when the related goods or services are transferred to the customer. For example, if the related services are transferred to the customer continuously and evenly over the amortization period, then straight-line amortization of the capitalized costs typically would be appropriate.

Capitalized contract costs are tested for impairment by comparing the carrying amount of the capitalized costs to an amount that considers the contract consideration an entity expects to receive in the future, the contract consideration the entity has already received but has not yet recognized as revenue and the direct costs related to transferring goods or services that remain to be recognized as an expense under the contract. For purposes of testing the capitalized costs for impairment, the time period reflected in the impairment test should take into consideration expected contract renewals and extensions with the same customer.

Once an impairment loss is recognized, it cannot be reversed under any circumstances.

Refer to Chapter 10 and Chapter 11 for discussion on issues that may arise when a distributor or asset manager applies this guidance.

4. Determining the customer

ASC 606 addresses revenue from contracts with customers. As such, it is important to determine whether any counterparty to the contract is a customer.

An asset manager may enter into contracts with funds, which are vehicles that allow investors to pool their money through the funds to benefit from an asset manager’s services. This situation raises the question as to whether the fund or the investor should be viewed as the customer. It is crucial for asset managers to make this determination first because it could affect the timing of revenue recognition and the accounting for certain costs (see Chapter 11).

Paragraphs 4.1.01 to 4.1.10 of the Revenue Recognition AAG address whether the fund or the investor is the asset manager’s customer and state there is no single determinative factor when identifying the customer. However, there are characteristics that may support a conclusion that the fund is the customer and, conversely, other characteristics that may support a conclusion that the investor is the customer. Asset managers should consider the specific facts and circumstances of each contract and the discussion in the Revenue Recognition AAG when evaluating whether the investor or the fund is the customer.

5. Management fee revenue, excluding performance fees revenue

This chapter addresses the application of each step in the ASC 606 five-step revenue recognition model to an asset manager’s contract to provide asset management services to its customer. The basis for this discussion is paragraphs 4.6.22 to 4.6.53 of the Revenue Recognition AAG.

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5.1 Step 1: Identifying the contract with a customer

As noted in Chapter 4, an asset manager should perform an analysis to determine who is the customer receiving the asset management services As noted in paragraph 4.6.22 of the Revenue Recognition AAG, the identification of the customer should not affect the asset manager's identification of the performance obligations (see Section 5.2) when it is providing asset management services or the accounting treatment for the revenue related to those services. However, that paragraph also points out that the identity of the customer may affect the revenue analysis when there are additional performance obligations (i.e., performance obligations beyond those related to asset management services) or the accounting for the related contract costs in accordance with ASC 340-40, given that the nature of the costs may be different depending on the identity of the customer (see Chapter 11).

Refer to Section 2.1 for additional considerations that apply when identifying the contract with a customer.

5.2 Step 2: Identifying the performance obligations in the contract

Paragraph 4.6.29 of the Revenue Recognition AAG notes that oversight and overall management of the fund or asset portfolio is either an explicitly or implicitly promised service provided over the contract term. In analyzing whether the promised services represent one or more performance obligations, paragraph 4.6.30 notes each increment (e.g., day, month, quarter) of asset management services is distinct.

In analyzing whether the series exception should be applied:

- Paragraph 4.6.31 indicates that it would be reasonable to conclude that each distinct increment of service is substantially the same.
- Paragraph 4.6.41 notes that each distinct increment of service is transferred over time because the customer simultaneously receives and consumes the benefits of the asset management services. In other words, another entity could step in and transfer the remaining distinct increments of service without having to substantially reperform the services already provided by the asset manager.
- Paragraph 4.6.43 indicates that each distinct increment of service would use a time-based measure of progress toward complete transfer of that increment of service.

Accordingly, paragraph 4.6.31 concludes that the series exception should be applied to a contract for asset management services, which results in the series of distinct increments of service being considered a single performance obligation. This conclusion is consistent with the discussion in paragraph 4.6.28 and the underlying purpose of the asset manager's promise, which is to provide the customer with an overall service of asset management.

5.3 Step 3: Determining the transaction price

When asset management fees are fixed (i.e., a set dollar amount) and paid at contractually specified intervals (e.g., quarterly), they are included in the transaction price at contract inception. Asset management fees that are tied to a measure of assets or capital (e.g., assets under management [AUM]) are a form of variable consideration. Investment management agreements typically require calculation of asset management fees based on either AUM as of a specific date (e.g., daily, monthly, quarterly) within a financial statement reporting period or AUM for a period of time not greater than a financial statement reporting period. While paragraph 4.6.34 of the Revenue Recognition AAG notes that the expected value method should be used to estimate the asset management fee to which the asset manager expects to be entitled, paragraph 4.6.36 concludes that the estimated management fee should usually only be included in the transaction price at the end of the applicable financial reporting period due to application of the variable consideration constraint. While each asset manager should make this determination based on its own facts and circumstances, applying that constraint to these types of asset management fees usually will result in a conclusion that it is less than probable that including an estimate of the fees in the transaction price will not result in a significant reversal of cumulative revenue recognized upon resolution

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of the uncertainty. As a result, the fees usually should be included in the transaction price when they can be calculated in accordance with the investment management agreement. For example, if a quarterly asset management fee is calculated based on the AUM at the end of each quarter and is not subject to any type of clawback, the fee usually should be included in the transaction price at the end of the quarter.

Refer to Chapter 6, Chapter 7 and Chapter 8 for discussion on how to determine the transaction price when the amount received by an asset manager is affected by a fee waiver, an incentive or performance fee, or an incentive-based capital allocation, respectively.

5.4 Step 4: Allocating the transaction price to the performance obligations

As discussed in Section 5.2, application of the series exception to asset management services results in the identification of a single performance obligation made up of multiple distinct increments of service. As a result, when the management fees are variable (see Section 5.3), the asset manager should determine whether those fees should be allocated to the single performance obligation in its entirety or to the distinct increments of service individually. If the terms of the payment are specifically related to the asset manager's efforts to transfer the distinct increment of service and allocating the payment to the individual distinct increment of service depicts the amount of consideration to which the asset manager expects to be entitled in exchange for transferring that increment of service to the customer when considering all of the payment terms in the contract, the variable payment is allocated to each individual distinct increment of service to which it relates. For example, for a quarterly asset management fee calculated based on AUM at the end of each quarter, if the quarterly asset management fee relates specifically to the asset manager's efforts to transfer the distinct increments of service for a specific quarter, the asset manager should allocate the quarterly asset management fee to the distinct increments of service provided during that quarter.

5.5 Step 5: Recognizing revenue when (or as) each performance obligation is satisfied

As discussed in Section 5.2, the distinct increments of service included in the single performance obligation of an asset manager are satisfied over time, and a time-based measure of progress toward complete transfer of that increment of service would be used to recognize revenue. As a result, paragraph 4.6.43 of the Revenue Recognition AAG notes that a time-based measure of progress toward complete satisfaction of the single performance obligation should be used to recognize revenue.

5.6 Unitary management fee arrangements

Unitary management fee arrangements include payment for investment advisory services, as well as a number of underlying operating services that are the responsibility of the asset manager. Under a unitary management fee arrangement, the overall promise by the asset manager to the customer is considered to be substantially the same from day to day, regardless of whether certain operating services may be performed during a particular time or times of the year, because the nature of the contract is to provide integrated management services as opposed to a specific quantity of specified services. In some cases, the governing documents may disclose the portion of the unitary fee attributable to the underlying operating services to be provided by the asset manager. Example 4-6-2 of the Revenue Recognition AAG notes that such disclosure should not dictate the distinct goods or services identified in a unitary management fee arrangement. In other words, such disclosure should not be the sole consideration in identifying the distinct goods or services. Example 4-6-2 also notes that the assessment of unitary management fee arrangements is the same as the assessment of a traditional management fee arrangement, which is discussed in Section 5.1 to Section 5.5.

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6. Management fee waivers and customer expense reimbursements

Management fee waivers and customer expense reimbursements may arise in connection with the contracts for asset management services, the accounting for which is discussed in detail in Chapter 5. This chapter addresses incremental considerations related to the application of ASC 606 to management fee waivers and customer expense reimbursements. The basis for this discussion is paragraphs 4.7.22 to 4.7.42 of the Revenue Recognition AAG.

Paragraph 4.7.22 notes that fee waivers should be accounted for as contract modifications when they are not executed concurrent with the establishment of an account or fund or the renewal of a contract. The accounting that results from applying the contract modifications guidance in ASC 606 depends on whether the fee waiver is executed before or after asset management services are provided. When the fee waiver is not executed concurrent with the renewal of a contract or the establishment of an account or fund and:

- *The fee waiver is executed before asset management services are rendered* (which is referred to as a Category 2 fee waiver in the Revenue Recognition AAG), paragraph 4.7.24 of the Revenue Recognition AAG notes that application of the contract modifications guidance in ASC 606 should result in prospective accounting for the waiver. In other words, the existing contract is accounted for as if it was terminated and the new contract (which includes the fee waiver) is accounted for on a going forward basis in accordance with the discussion in Chapter 5.
- *The fee waiver is executed after asset management services are rendered* (which is referred to as a Category 3 fee waiver in the Revenue Recognition AAG), paragraph 4.7.26 of the Revenue Recognition AAG indicates that application of the contract modifications guidance in ASC 606 should result in a cumulative catch-up adjustment. In other words, the fee waiver is reflected in the accounting for the existing contract by adjusting the transaction price (as appropriate) and remeasuring the amount of revenue that should be recognized to date under the contract.

When the fee waiver is executed concurrent with the renewal of a contract or the establishment of an account or fund (which is referred to as a Category 1 fee waiver in the Revenue Recognition AAG), paragraph 4.7.28 notes that the asset manager should apply the contract combination guidance in ASC 606. In applying this guidance, paragraph 4.7.29 further concludes that the fee waiver and contract should be combined for accounting purposes.

When the amount of the fee waiver is variable, paragraph 4.7.35 notes such waiver should be evaluated as variable consideration. Consistent with the discussion in Section 5.3, paragraph 4.7.35 concludes that the expected value method should be used to estimate the expected effects of the fee waiver on the transaction price. In addition, while each asset manager should make this determination based on its own facts and circumstances, paragraph 4.7.39 of the Revenue Recognition AAG notes that the fee waiver usually should result in a constraint of the variable consideration.

7. Incentive or performance fee revenue, excluding incentive-based capital allocations

Incentive or performance fees may arise in connection with contracts for asset management services, the accounting for which is discussed in detail in Chapter 5. This chapter discusses incremental considerations related to the application of ASC 606 to incentive or performance fees. The basis for this discussion is paragraphs 4.6.54 to 4.6.80 of the Revenue Recognition AAG.

An incentive or performance fee is considered variable consideration because it is subject to fluctuation and its payment is contingent on the occurrence or nonoccurrence of a future event. In applying the

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variable consideration guidance, which is discussed in Section 2.3 of this whitepaper, paragraph 4.6.66 of the Revenue Recognition AAG notes the factors that should be considered by the asset manager in estimating the amount of incentive or performance fee to which it expects to be entitled using either the expected value method or the most likely amount method. Two of those factors are:

- What is the asset manager's relevant historical experience with incentive or performance fees in similar situations?
- What is the asset manager's track record with respect to accurately predicting fund performance?

In applying the variable consideration constraint to the estimated amount of incentive or performance fee to which the asset manager expects to be entitled, revenue should only be recognized prior to the end of the performance period if the relevant facts and circumstances indicate that it is probable that significant reversal will not occur. Paragraph 4.6.69 of the Revenue Recognition AAG provides the following questions for asset managers to consider when making this assessment:

- To what degree is the estimated incentive or performance fee subject to future changes in the underlying investment portfolio due to market volatility, investment and reinvestment?
- Does the return on investment exceed the contractual hurdle rate and, if so, to what extent?
- How much time remains in the performance period?

The asset manager will need to exercise significant judgment in applying the variable consideration guidance in ASC 606 to its facts and circumstances when determining whether some, none or all of the estimated incentive or performance fee should be included in the transaction price at contract inception or at other points in time before the underlying uncertainty is resolved.

If an asset manager concludes that some or all of the incentive or performance fee should be included in the transaction price before the underlying uncertainty is resolved, consideration must be given to allocating that variable consideration to one or more distinct increments of service as discussed in Section 5.4. In addition, as discussed in Example 4-6-3 of the Revenue Recognition AAG, the asset manager should evaluate how much of the incentive or performance fee should be recognized in the current period (because it relates to services provided in prior periods or the current period) and how much of that fee should be deferred and recognized over the remaining service period (because it relates to services that will be provided in future periods).

8. Incentive-based capital allocations

Paragraphs 4.6.81 to 4.6.93 of the Revenue Recognition AAG address the issues that arise under ASC 606 when accounting for incentive-based capital allocations (such as a carried interest) the asset manager may receive in connection with providing asset management services to its customers.

The first key question with respect to accounting for incentive-based capital allocations is whether the arrangements that provide for such allocations should be accounted for as revenue under ASC 606 or equity interests under other applicable guidance in the ASC, such as the guidance on consolidation (including the guidance on consolidating variable interest entities) or the equity method of accounting. This issue was discussed by the FASB's Transition Resource Group (TRG), and a summary of these discussions is provided in paragraph 4.6.84 of the Revenue Recognition AAG. The views expressed regarding how asset managers should account for arrangements that provide for incentive-based capital allocations were:

- Many TRG members concluded that such arrangements should be accounted for as revenue under ASC 606. Only a few TRG members indicated that they understood a view that such arrangements should be accounted for as an equity interest under other applicable guidance in the ASC.

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- The FASB staff involved in the TRG discussions stated their view that such arrangements should be accounted for as revenue under ASC 606.
- All seven members of the FASB were present during the TRG's discussions, and they shared a view that such arrangements should be accounted for as revenue under ASC 606.
- The SEC staff observer present during the TRG's discussions indicated that he expects the SEC staff to accept a position that such arrangements should be accounted for as revenue under ASC 606. However, he also indicated that there may be a basis to account for such arrangements as equity interests under other applicable guidance in the ASC.

If an entity has an accounting policy to account for arrangements with incentive-based capital allocations as equity interests, and other applicable guidance in the ASC results in applying the equity method of accounting to those equity interests, careful consideration should be given to the income statement presentation of any related equity method income or loss.

The remainder of this section focuses on providing guidance for situations in which incentive-based capital allocations are accounted for under ASC 606.

Arrangements that provide for incentive-based capital allocations may arise in connection with contracts for asset management services, which are discussed in detail in Chapter 5. Incremental considerations related to applying ASC 606 to incentive-based capital allocations are discussed in this chapter; the basis for this discussion is paragraphs 4.6.86 to 4.6.93 of the Revenue Recognition AAG.

For purposes of applying the variable consideration guidance discussed in Section 2.3 that indicates an asset manager should estimate the amount of incentive-based capital allocation to which it expects to be entitled using either the expected value method or the most likely amount method, refer to the related discussion in Chapter 7.

In applying the variable consideration constraint, paragraph 4.6.87 of the Revenue Recognition AAG refers to the factors provided in paragraph 4.6.69 related to applying the variable consideration constraint to incentive or performance fees (which are discussed in Chapter 7). In addition, paragraphs 4.6.69 and 4.6.70 include the following additional factors that should be considered by an asset manager when applying the variable consideration constraint to incentive-based capital allocations:

- To what degree is the estimated allocation subject to future changes as a result of factors such as investment company performance waterfalls, hurdle rates or investment-by-investment calculations?
- Are there any clawback or similar provisions related to the incentive-based capital allocation?
- What is the remaining life of the investment company?
- Could the excess unrealized return be affected by factors outside the asset manager's influence? For example, could the excess unrealized return be affected by fluctuations in the fair value of the portfolio of investments used in calculating the allocation?
- Is the sum of the current realized return and the unrealized gains on investment more than the contractual hurdle rate and, if so, to what extent?

The variable consideration constraint requires determining whether it is probable that including the estimate of the incentive-based capital allocations in the transaction price will not result in a significant reversal of cumulative revenue recognized when the uncertainty underlying the allocation is resolved. While each asset manager should make this determination based on its own facts and circumstances, paragraph 4.6.90 notes that the incentive-based capital allocation generally may be considered significant for purposes of applying the constraint, given its potential to be greater than other fees in the overall fee structure.

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The asset manager must exercise significant judgment in applying the variable consideration guidance in ASC 606 to its facts and circumstances when determining whether some, none or all of an estimated incentive-based capital allocation should be included in the transaction price at contract inception or at other points in time before the underlying uncertainty is resolved.

If an asset manager concludes that some or all of the incentive-based capital allocation should be included in the transaction price before the underlying uncertainty is resolved, consideration must be given to allocating that variable consideration to one or more distinct increments of service as discussed in Section 5.4. In addition, as discussed in paragraph 4.6.92 of the Revenue Recognition AAG, the asset manager should evaluate how much of the incentive-based capital allocation included in the transaction price should be recognized over the remaining performance period.

9. Recognition of contingent deferred sales charges (CDSC fees)

Paragraphs 4.6.01 to 4.6.18 of the Revenue Recognition AAG address the issues that arise when a distributor accounts for CDSC fees.

Paragraph 4.6.02 concludes that CDSC fees included in a contract fall within the scope of ASC 606. As such, this chapter discusses the application of each step in the ASC 606 five-step revenue recognition model to a contract that includes CDSC fees. The basis for this discussion is paragraphs 4.6.04 to 4.6.18 of the Revenue Recognition AAG.

9.1 Step 1: Identifying the contract with a customer

CDSC fees represent revenue earned by the distributor from contracts with its customers. As noted in Chapter 4, an analysis must be performed to determine whether the customer is the fund or the investor. While each distributor should make this determination based on its own facts and circumstances, paragraph 4.6.06 of the Revenue Recognition AAG indicates that the fund is assumed to be the customer for purposes of this analysis because this reflects the nature of the distributor's ordinary business activities, which involve selling or distributing the fund's securities and receiving fees from the fund in return.

Refer to Section 2.1 for additional considerations that apply when identifying the contract with a customer.

9.2 Step 2: Identifying the performance obligations in the contract

Refer to Section 2.2 for an overall summary of how the performance obligations in a contract are identified under ASC 606.

While each distributor should make this determination based on its own facts and circumstances, paragraph 4.6.10 of the Revenue Recognition AAG concludes that application of Step 2 generally should result in the sales-related services provided by a distributor in exchange for CDSC fees being considered a single performance obligation.

9.3 Step 3: Determining the transaction price

Refer to Section 2.3 for an overall summary of how the transaction price (i.e., the amount ultimately recognized as revenue) is determined under ASC 606.

Paragraph 4.6.13 of the Revenue Recognition AAG indicates that CDSC fees are contingent upon the investor's redemption of its shares in the fund and vary based on the sales proceeds from that redemption. As a result, CDSC fees should be accounted for as variable consideration under ASC 606.

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In estimating the amount of CDSC fees to which the distributor expects to be entitled, the distributor should use either the expected value method or the most likely amount method as discussed in Section 2.3. Once the distributor has estimated the amount of CDSC fees to which it expects to be entitled, it then applies the variable consideration constraint. While each distributor should make this determination based on its own facts and circumstances, paragraph 4.6.16 of the Revenue Recognition AAG concludes that CDSC fees generally should be constrained (i.e., not included in the transaction price) until the fund redeems the investor's shares.

9.4 Step 4: Allocating the transaction price to the performance obligations

As discussed in Section 9.2, sales-related services provided by a distributor in exchange for CDSC fees generally are considered a single performance obligation. As a result, there is no need to allocate the transaction price. However, if there is more than one performance obligation (e.g., other services are provided in addition to the sales-related services) as a result of applying Step 2 of the revenue recognition model, refer to the overall summary in Section 2.4 for information on how to allocate the transaction price to each of the identified performance obligations.

9.5 Step 5: Recognizing revenue when (or as) each performance obligation is satisfied

Refer to Section 2.5 of this white paper for an overall summary of recognizing revenue when (or as) each performance obligation is satisfied under ASC 606.

A distributor should apply the criteria discussed in Section 2.5 to determine whether the performance obligation made up of the sales-related services is satisfied over time. If none of those criteria are met, then the performance obligation is satisfied at a point in time. Paragraph 4.6.18 of the Revenue Recognition AAG indicates that a performance obligation for which the underlying promised service consists of the sale of fund shares may be considered satisfied at a point in time (i.e., the date the trade was executed) based on applying the criteria discussed in Section 2.5 to its facts and circumstances. To reach this conclusion, paragraph 4.6.18 of the Revenue Recognition AAG also indicates that the distributor also would have had to conclude that the ancillary sales and marketing activities performed in connection with selling the fund shares were not promised services to the fund under ASC 606.

10. Deferred distribution commission expenses (back-end load funds)

The issues that arise when a mutual fund distributor incurs distribution commission costs on back-end load funds are addressed in paragraphs 4.7.01 to 4.7.10 of the Revenue Recognition AAG, which are the basis for the discussion in this chapter. For additional information and context, refer to the AAG.

Based on the guidance in ASC 946-720-25-4, mutual fund distributors should defer and amortize the incremental direct distribution commission costs incurred on back-end load funds and expense the indirect costs when incurred. Given the lack of amortization and impairment guidance in ASC 946-720-25-4, paragraphs 4.7.08 to 4.7.10 of the Revenue Recognition AAG include the following conclusions related to the mutual fund distributor's subsequent accounting for deferred distribution commission costs:

- *The amortization guidance in ASC 340-40-35-1 may be applied by the mutual fund distributor.* As a result, based on the discussion in Chapter 3, deferred distribution commission costs may be amortized in a manner (and over a period) that is consistent with how (and when) the related services are transferred to the customer.
- *Deferred distribution commission costs should be evaluated for impairment, and the guidance in ASC 340-40-35-3 to 35-6 may be applied by the mutual fund distributor in doing so.* As a result, based on the discussion in Chapter 3, the mutual fund distributor may recognize an impairment loss for the excess of the carrying amount of the deferred costs for a contract over the recoverable amount for

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that contract, which is the difference between the remaining consideration the mutual fund distributor expects to receive in return for providing services under the contract and the remaining direct costs associated with providing services under the contract that the mutual fund distributor expects to recognize as an expense. If the mutual fund distributor recognizes an impairment loss, it is not reversed under any circumstances.

11. Costs of managing investment companies

This chapter addresses the accounting for various costs incurred to manage investment companies. The following summarizes the conclusions included within paragraphs 4.7.50 to 4.7.72 of the Revenue Recognition AAG. In some cases, the accounting for these costs depends on whether the customer is the investment company or the investor (which is discussed in Section 2.1):

- Regardless of whether the investment company or investor is the customer, the following costs should be evaluated as indicated:
  - *Organization and offering costs related to launching a new investment vehicle*. Based on the conclusions in paragraphs 4.7.53 and 4.7.68, such costs generally should be expensed as incurred based on the guidance in ASC 720-15, "Other Expenses – Start-Up Costs."
  - *Asset allocator fees*. Based on the conclusions in paragraph 4.7.62, such costs should be evaluated as costs to fulfill a contract with a customer. While each asset manager should make this determination based on its own facts and circumstances, paragraph 4.7.72 notes that most fulfillment costs incurred by asset managers generally will not meet the capitalization criteria for such costs, which are discussed in Chapter 3.
- When the investment company is the customer, based on the conclusions in paragraphs 4.7.60 and 4.7.62, the following costs should be evaluated as costs to fulfill a contract with a customer:
  - Discretionary or nondiscretionary sales commissions paid to either the asset manager's wholesalers (employees) or third-party broker-dealers
  - Placement fees

  While each asset manager should make this determination based on its own facts and circumstances, paragraph 4.7.72 notes that most fulfillment costs incurred by asset managers or distributors generally will not meet the capitalization criteria for such costs, which are discussed in Chapter 3.
- When the investor is the customer, based on the conclusions in paragraphs 4.7.61 and 4.7.62, the following costs should be evaluated as costs to obtain a contract:
  - Nondiscretionary sales commissions paid to either the asset manager's wholesalers (employees) or third-party broker-dealers
  - Placement fees

  Based on the discussion in Chapter 3 about costs to obtain a contract, these costs should be capitalized if they are expected to be recovered unless the costs are eligible for the related practical expedient and the asset manager elects to apply the practical expedient.

12. Asset management arrangement revenue: gross versus net

Issues that arise in determining whether an asset manager should be considered a principal or an agent in certain situations are addressed in paragraphs 4.6.94 to 4.6.107 of the Revenue Recognition AAG.

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The principal versus. agent guidance in ASC 606 only is applied when another party is involved with the entity in providing the promised goods or services to the customer. This situation arises with an asset manager when it hires a third party to provide one or more elements of the asset management services (e.g., advisory services, fund management) to the customer. In this situation, the asset manager must determine whether it should recognize revenue related to those services gross as a principal or net as an agent.

There are two key steps in the principal versus agent guidance in ASC 606: identifying the specified goods or services being provided to the customer and determining whether the entity obtains control of the specified goods or services before transferring control of those goods or services to the customer. The conclusions included in paragraphs 4.6.94 to 4.6.107 of the Revenue Recognition AAG related to applying each of these steps and the related accounting repercussions are discussed further in this chapter. In addition, Example 4-6-8 of the Revenue Recognition AAG addresses whether out-of-pocket expense reimbursements should be included in the transaction price, which is discussed in Section 12.4.

12.1 Identifying the specified goods or services being provided to the customer

Identifying the specified goods or services being provided to the customer in a contract for asset management services involves identifying all of the promises to provide goods or services in the contract and then determining whether those promised goods or services are distinct, which is the same concept of distinct used in identifying the performance obligations in a contract (see the related discussion in Section 5.2). While paragraph 4.6.99 of the Revenue Recognition AAG lists various types of activities an asset manager may undertake to provide asset management services to a customer (e.g., fund administration, distribution), it concludes that many of these activities are undertaken in support of providing the promised asset management services. This is consistent with the discussion in Section 5.2, which notes that each increment (e.g., day, month, quarter) of overall asset management services is considered distinct.

12.2 Determining whether the asset manager obtains control of the specified goods or services provided by the third party before transferring control to the customer

Obtaining control of the specified goods or services provided by the third party before transferring control of those goods or services to the customer can happen in any of the following circumstances (which will be referred to as the control circumstances):

- The asset manager obtains control of a good or another asset from the third party and then transfers that good or other asset to the customer.
- The asset manager obtains control of a right to services from a third party (e.g., fund administrator) and has the ability to direct the third party in providing the specified services to the customer on the asset manager's behalf.
- The asset manager obtains control of a service from the third party that the asset manager then combines with other services to provide the specified services to the customer.

For purposes of determining whether the asset manager obtains control of the good, other asset, service or right to a service, the asset manager should consider whether it has the ability to direct the use of the good or service and receive substantially all of the related remaining benefits (which includes the entity being able to stop others from directing the use of the good or service and receiving substantially all of the related remaining benefits). Refer to Examples 4-6-6 and 4-6-7 of the Revenue Recognition AAG (which address third-party services provided in conjunction with a unitary management fee arrangement and a distribution agreement, respectively) to understand how each of the control circumstances should be evaluated with respect to the services provided by an asset manager.

In some cases, an analysis of whether one or more of the control circumstances exists in a particular situation will conclusively indicate whether the asset manager should report revenue gross as a principal

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or net as an agent. In those cases, the asset manager does not need to perform any further analysis. However, in cases where the analysis of the control circumstances is not conclusive, the asset manager should consider the following questions:

- Is it primarily responsible for fulfilling the promise to provide asset management services (including those provided by the third party) to the customer?
- Does it have inventory risk?
- Does it have discretion in setting the prices charged to the customer for the asset management services (including those provided by the third party)?

Each of these indicators is discussed further in this section. With respect to using these indicators in the overall evaluation of whether the asset manager obtains control of the asset management services provided by a third party (or the right to such services), it is important to keep in mind that these indicators contribute to that overall evaluation and do not override it.

12.2.1. Primarily responsible for fulfilling the promise to provide asset management services

Based on its own facts and circumstances, each asset manager should make the determination of who is primarily responsible for fulfilling the promise to provide the asset management services. Paragraph 4.6.104(a)(i) of the Revenue Recognition AAG indicates that the asset manager may be primarily responsible for fulfilling the promise to provide asset management services (including those provided by the third party) to the customer if one or more of the following statements are true:

- The asset manager is responsible to the customer for the services provided by the third party.
- The customer's interaction with the third party is limited or nonexistent.
- The customer has the right to remedies (e.g., fee waivers, financial payments) from the asset manager if the third party does not provide an acceptable level of service.
- If the customer is dissatisfied with the third party's performance, the customer has the right to terminate its contract with the asset manager or require remediation by the asset manager.
- The customer is not a party to the contract between the asset manager and the third party and does not have the right to engage and direct the activities of the third party.

The asset manager also may consider whether it (and not the customer) has the discretion to select an acceptable third party (i.e., one that can meet the customer's requirements) to provide services to the customer. If so, that would support other factors that indicate the asset manager is primarily responsible for fulfilling the promise to provide asset management services to the customer.

Paragraph 4.6.104(a)(ii) indicates that the asset manager may not be primarily responsible for fulfilling the promise to provide asset management services (including those provided by the third party) to the customer if one or both of the following statements are true:

- The contract is between the asset manager, third party and customer, and the customer has the right to engage and direct the activities of the third party.
- The customer has the right to amend or terminate the contract with the third party.

12.2.2. Inventory risk

While inventory risk is one of the indicators included in the principal vs. agent guidance in ASC 606, it typically will not support the asset manager concluding it is a principal in providing the asset management services (including those provided by the third party) to the customer because the services are not physically inventoriable and the asset manager does not commit to acquiring the services from the third party before the services are provided to the customer.

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12.2.3. Discretion in setting prices

Paragraph 4.6.104(c) of the Revenue Recognition AAG provides the following guidance:

- The asset manager having ultimate discretion in setting the prices charged to the customer for the services provided by the third party may be an indication that the asset manager controls the services before they are transferred to the customer.
- The asset manager having only a limited ability to set the prices charged to the customer for the services provided by the third party may be an indication that the asset manager does not have discretion in setting the prices charged to the customer. The limited ability the asset manager has may relate solely to establishing the incremental amount it will receive from the customer for coordinating the provision of services by the third party.
- The customer's knowledge of how much the third party is charging the asset manager for the services provided to the customer by the third party does not on its own keep the asset manager from concluding that it controls the services before they are transferred to the customer.

12.3 Accounting repercussions

If the asset manager obtains control of the asset management services provided by a third party (or the right to such services) before transferring control of those services to the customer, the asset manager is acting as a principal and should include the gross amount of consideration related to the asset management services in the transaction price (which is the amount ultimately recognized as revenue). If not, the asset manager is acting as an agent and should include the net fee to which it expects to be entitled for arranging to have the third party provide certain asset management services to the customer in the transaction price.

12.4 Out-of-pocket expense reimbursements

Example 4-6-8 within the Revenue Recognition AAG addresses out-of-pocket expenses incurred by an asset manager in connection with carrying out its contractual obligation to provide asset management services to a customer. Examples of these costs include due diligence-related travel expenses and fees for legal and other professional services. The conclusion reached in the example is that amounts billed to the customer for these out-of-pocket expenses should be reflected in the transaction price. In other words, the amounts billed to the customer should be reflected as revenue on a gross basis and the costs reflected as an expense.

The example also discusses the customer making payments to the asset manager for taxes and fees the asset manager pays on the customer's behalf (e.g., filing and regulatory fees). The conclusion reached in the example indicates that these reimbursements should not be reflected in the transaction price because they do not represent a cost the asset manager incurs to provide services to the customer. Instead, these reimbursements represent costs of the customer that the asset manager is remitting to third parties (e.g., a regulatory agency) on its customer's behalf.

13. Disclosures

Many qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): "The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

The disclosures required to achieve this objective focus on providing a variety of revenue-related information. Some of the information that must be disclosed is high-level, such as the amount of revenue

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recognized from customer contracts and the amount of any impairment (or credit) losses recognized on receivables or contract assets related to customer contracts. However, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations
- Transaction price allocated to remaining performance obligations at the end of the reporting period (disclosures required for public entities and elective for nonpublic entities)
- Significant judgments about the timing of satisfying performance obligations
- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (disclosures required for public entities and elective for nonpublic entities)
- Capitalized costs related to obtaining or fulfilling a customer contract (disclosure required for public entities and elective for nonpublic entities)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the asset management entity is a public entity (more required disclosures) or nonpublic entity (fewer required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required of public entities for interim periods. However, when an asset management entity applies ASC 606 and 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and 340-40 in its annual financial statements, the asset management entity must provide all the required annual disclosures in those interim financial statements.

Detailed discussion and illustrations of the disclosure requirements for both public and nonpublic entities are included in Chapter 15 of our revenue recognition guide.

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