June 1, 2017

Working Draft:

Asset Management Revenue Recognition Implementation Issue

Issue # 10-2: Management Fee Revenue, excluding Performance Fee Revenue

Expected Overall Level of Impact to Industry Accounting:

Moderate

Wording to be Included in the Revenue Recognition Guide:

Background - Management fees.

1. Management fees are generally asset-based fees received from managed accounts or from pooled investment vehicles (that is, funds) in exchange for asset management services. In addition to investment advisory services, in many cases the asset manager is also responsible for ensuring the proper functioning of fund operations, which includes engaging and monitoring applicable third-party service providers who perform services such as record-keeping, administration, custody, transfer agency, and fund accounting. These services allow the customer to continue operating and reporting in compliance with applicable laws and regulations. These services are performed and provide benefit to the customer consistently over a given time period. The management fee is typically calculated as a percentage of gross or net assets at a point in time or the average of such assets over a given period (such as daily, monthly, or quarterly), and the billing terms of the fee (both timing, for example, in arrears or in advance, and frequency) are included in the investment management agreement ("IMA") that is entered into between the asset manager and the customer. For example, an asset manager may be paid a fee per annum of 1 percent of daily net assets to manage a mutual fund for a one-year time period[1]. The mutual fund is required to pay 1/365 of 1 percent of each day's net assets for every day that the asset manager manages the fund, with the fee payable the first of the following month. Application of the revenue recognition model in FASB ASC 606 to management fees in a contract with a customer to provide asset management services is illustrated in FASB ASC 606-10-55-221 through 55-225 of Example 25.

2. For purposes of the following analysis, assume that entitlement to and amount of management fees do not depend on the performance of the investments under management meeting specified investment return thresholds and that there is no associated clawback provision[2].

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[1] In certain instances, management fees may be structured as fixed fees. In these instances, asset management services are provided in exchange for fixed amounts of consideration paid at contractually specified intervals (for example, quarterly).

[2] A clawback provision is a feature in a contract that requires the asset manager to return all or a portion of the previously allocated and distributed fees. There is often associated complex legal language and calculations to determine the amount of the clawback provision.

3. Considerations relevant to evaluating performance fees are discussed in detail within the issues 10-5 "Incentive or Performance Fee Revenue, excluding incentive-based capital allocations (such as carried interest)" and 10-5AB "Incentive-Based Capital Allocations".

Identify the contract with a customer (FASB ASC 606-10-25-1 through 25-99)

4. Industry considerations relevant to determining the customer and evaluating the contract are discussed in detail within the issues 10-1 "Determining the Customer in an Asset Management Arrangement" and 10-8 "Identifying the Contract". FinREC believes that irrespective of whether the fund or investor is identified as the customer for purposes of applying Topic 606 to the promise to provide asset management services, the identified performance obligations and corresponding accounting treatment discussed herein will not differ. However, the revenue recognition analysis may differ depending on the existence of *other* performance obligations and also application of the cost guidance in FASB ASC 340-40 may differ based on the nature of the cost.

Identify separate performance obligations (FASB ASC 606-10-25-14 through 25-22)

5. When evaluating management fees, an entity should identify the performance obligations. FASB ASC 606-10-25-14 describes a performance obligation as "…a promise to transfer to the customer either:
   a. A good or service (or a bundle of goods or services) that is distinct.
   b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15)."

6. For a promised good or service to be distinct, both of the following criteria in FASB ASC 606-10-25-19 must be met:
   a. 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 (that is, the good or service is capable of being distinct).
   b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

7. Several steps are involved in applying the above guidance, starting with identifying all of the promised goods or services in the contract. Services promised to the customer may be described in an IMA and/or a prospectus. While in many cases all of the promised goods or services might be identified explicitly in the contract, FASB ASC 606-10-25-16 notes that they may be implicit as well: "a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer." Moreover, FASB ASC 606-10-25-18 provides examples of promised services, including:

   > "(d) Performing a contractually agreed-upon task (or tasks) for a customer.
   > (e) Providing a service of standing ready to provide goods or services . . . or of making goods or services available for a customer to use as and when the customer decides.
   > (f) Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party . . .). "

8. An entity should consider the specific terms of a given IMA, and the unique facts and circumstances of the arrangement, including the entity's prior business practices, when identifying explicit and implicit promises in addition to the performance of asset management services.

9. Once promises in the contract have been identified, an entity must then identify the performance obligations. A promised service can be a performance obligation if it meets the distinct criteria either on:
   a. A standalone basis, or
   b. A combined basis together with other promises because either
      i. each service is not distinct (hence they are "bundled" together), or
      ii. each service is distinct but the criteria are met that require them to be accounted for as a series.

   In all instances, the guidance on determining whether a promise is distinct in FASB ASC 606-10-25-19 through 25-22 must be applied.

10. Consistent with Example 25, in FASB ASC 606-10-55-222, the promise to provide asset management services is considered a single performance obligation in accordance with FASB ASC 606-10-25-14(b) as it requires the provision of a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress). The promise to provide asset management services often encompasses the provision of

supporting administrative activities, such as providing regulatory compliance services, ensuring that the investment company complies with applicable stock exchange listing requirements, negotiating contractual agreements with third party providers of services, overseeing the determination and publication of the investment company's net asset value, and overseeing the preparation and filing of the investment company's tax return (as applicable). These services are considered ancillary and part of the nature of the promised asset management service to the customer).).

11. In evaluating the nature of the asset manager's promise to provide asset management services, FinREC believes that the asset manager either explicitly or implicitly creates a reasonable expectation of the customer that the asset manager will provide oversight and overall management of the fund or portfolio of assets. Governing documents for funds, such as the prospectus, often explain that the asset manager has ultimate responsibility for managing each fund's investment and business operations, subject to the oversight of the fund's board (if applicable). Also, governing documents typically highlight that this authority has been delegated to the asset manager under a separate management agreement entered into with the fund. The asset manager often serves as manager of a fund pursuant to an investment advisory agreement or other management agreement entered into between them and the fund. Fund management responsibilities often involve negotiating the terms of and subsequently monitoring adherence to service provider agreements with third-party service providers (for example, custodian, fund administrator, transfer agent and registrar, auditor, distributor, and fund accountant), determining or confirming the net asset value of the fund, and raising any material service performance issues (as well as possible resolutions) to the fund's board, amongst other duties.

12. FinREC believes that each increment of asset management service is distinct because the customer can benefit from each day of service on its own and each day of service is separately identifiable. Each day's service is separately identifiable because:
    a. The asset manager does not provide an integration service between the days. While the various underlying activities are generally coordinated and are inputs to the combined asset management service, each day that those combined activities are provided is not an input to a combined output. Also, the utility to the customer of asset management services performed on any given day is not significantly affected by such services performed on another day. While certain services performed on any given day may impact actions that are ultimately taken on another day, such as investment research activities or analysis of ongoing market developments, they are not considered inputs to services performed on those other days, because until the asset manager actually undertakes an action, (i) the customer does not receive the utility of prior activities undertaken, and (ii) prior activities may be rendered obsolete by current market events and reaction required to address customer needs.
    b. Each day does not modify or customize the services provided on another day.
    c. The days of service are generally not highly interdependent or interrelated because the entity can fulfill its obligations each day independent of fulfilling its obligations for the other days.

13. With respect to the 'substantially the same' criterion, FinREC believes it is reasonable to conclude that each day of service is substantially the same because the nature of the asset manager's promise to the customer is one overall service. Even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day. Therefore, the asset manager has promised the daily investment management service (as opposed to promising to deliver a specified amount of each underlying activity) and the conditions are met for the promise to provide asset management services to represent a single performance obligation based on the series guidance in FASB ASC 606-10-25-15.

Determining the transaction price (FASB ASC 606-10-32-2 through 32-4)

14. In accordance with FASB ASC 606-10-32-2, the total transaction price is the amount of consideration the asset manager expects to receive for performing asset management services and includes both fixed and variable amounts. The amount of the transaction price that the asset manager will recognize as revenue is comprised of management fees, and incentive or performance fees, if applicable. Any amount of fees that are variable are subject to the constraint described in ASC 606-10-32-11 to 32-12. Refer to the discussion of the accounting for performance fees within the issues 10-5 "Incentive and Performance Fee Revenue, excluding incentive-based capital allocations (such as carried interest)" and 10-5AB "Incentive-Based Capital Allocations". As well, consideration should be given to any fee waivers, including expense caps. Considerations relevant to evaluating fee waivers, including expense caps, are discussed in detail within the issue 10-3 "Management Fee Waivers and Customer Expense Reimbursements".

Determining the transaction price—Variable consideration (FASB ASC 606-10-32-5 through 32-13)

15. In accordance with FASB ASC 606-10-32-6, consideration paid for asset management services in the form of management fees that is tied to a measure of assets or capital, such as assets under management ("AUM"), is variable consideration because the amount of these fees is subject to fluctuation based on changes in AUM.

16. As a form of variable consideration, management fees are estimated based on terms contained in the IMA as of contract inception. This estimate must be updated each financial statement reporting period ("reporting period"); for internal reporting purposes, more frequent updates may occur. FinREC believes that the expected value method (sum of probability weighted amounts) will best predict the amount of management fees that the asset manager will be entitled to given the large number of possible consideration amounts as discussed in FASB ASC 606-10-32-8. However, before including an estimate of management fees in the transaction price, consideration must be given to whether the constraint should be applied.

17. The amount of variable consideration that can be included 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. The management fee is typically calculated based either (a) on AUM as of a date or dates within a given reporting period, or (b) on AUM for a period of time that is not greater than a reporting period. The element of variability relative to management fees relates to the fact that the fees are based on the AUM and the AUM can vary each day. The date of the measurement period and reporting period will often align.

18. Consequently, management fee in its entirety can usually only be included in the transaction price at the end of each reporting period. FinREC believes that, prior to this date, estimate of the management fee likely would be constrained from inclusion in the transaction price based on the guidance in FASB ASC 606-10-32-11 through 32-13. The promised consideration is dependent on the market and thus is highly susceptible to factors outside the asset manager's influence. In addition, management fees typically have a large number and broad range of possible consideration amounts. Although the asset manager may have experience with similar contracts, that historical experience is of little predictive value in determining the future performance of the market.

Allocating the transaction price to performance obligations (FASB ASC 606-10-32-28 through 25-35*)*

19. For contracts with more than one performance obligation or that contain a single performance obligation comprised of a series of distinct goods or services, the transaction price must be allocated to each performance obligation or, if certain conditions are met, to each distinct good or service in the series (for example, to each daily provision of service). In accordance with FASB ASC 606-10-32-29, the transaction price should be allocated to each performance obligation identified on a relative standalone selling price basis (determined as of contract inception), except as specified for allocating discounts in FASB ASC 606-10-32-36 through 606-10-32-38 and for allocating variable consideration in FASB ASC 606-10-32-39 through 606-10-32-41.

20. In order to allocate a variable amount (and subsequent changes to that amount) entirely to one or more, but not all, performance obligations or to one or more, but not all, distinct services promised in a series of distinct services that forms part of a single performance obligation, as in the case of a performance obligation to provide asset management services, both of the following criteria in FASB ASC 606-10-32-40 must be met:
    a. The terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service, and
    b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in FASB ASC 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

21. FASB ASC 606-10-32-28 states that the objective of allocating the transaction price to performance obligations is to allocate 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 to the customer. Allocating management fees to each reporting period would meet the allocation objective because the amount allocated corresponds to the value provided to the customer for that period.

22. The following examples for management fees and unitary management fees are meant to be illustrative, and the actual determination of the amount and timing of fees recognized in revenue should be based on the facts and circumstances of an entity's specific situation.

    Example – management fees

    Pursuant to an IMA, an asset manager is paid a fee per annum of 1 percent of daily net assets to manage a mutual fund for a one-year time period. The mutual fund is required to pay 1/365 of 1 percent of each day's net asset value for every day that the asset manager manages the fund, with the fee payable in arrears (the first business day of each following month). The days of asset management service collectively form a single performance obligation pursuant to the series guidance. This is because the service performed each day is substantially the same and has the same pattern of transfer to the customer (over time). Each period of service lasts one day, asset management services are performed every business day, and the customer receives and consumes the benefits of the performed services as the asset manager provides them. The transfer of services is continuous and the asset manager has a right to consideration from the fund in an amount that corresponds directly with the value to the fund of the asset manager's performance completed to date. Accordingly, the criteria in FASB ASC 606-10-32-40 relating to the allocation of variable consideration would likely be met. If so, the asset manager must allocate the transaction price and recognize revenue relating to the performance of daily asset management services over the given month, calculated by multiplying the 1 percent management fee by the fund's respective day's net assets divided by the number of days in the year.

The above example is consistent with Example 25 of FASB ASC 606. Specifically, in FASB ASC 606-10-25-225, the guidance explains that at "the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with FASB ASC 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in FASB ASC 606-10-32-28."

Satisfaction of the performance obligations (FASB ASC 606-10-25-23 through 25-32*)*

For each performance obligation, an entity shall determine at contract inception whether it satisfies the performance obligation over time or at a point in time, as explained in FASB ASC 606-10-25-24. The guidance in FASB ASC 606-10-25-27, and related paragraphs, is applied to determine whether a performance obligation is satisfied over time. Applying this guidance to a series of distinct goods or services that collectively represents a single performance obligation means that each of those promised goods or services must be a performance obligation satisfied over time (FASB ASC 606-10-25-15(a)). The nature of the promise in providing the services informs the unit of accounting to which the guidance on satisfaction of a performance obligation applies. With respect to the promise to provide daily asset management services, each increment of service performed (that is, each daily investment management service) is the applicable unit of accounting to which the three criteria in FASB ASC 606-10-25-27 is applied. The three criteria are:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see FASB ASC 606-10-55-5 through 55-6).
b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see FASB ASC 606-10-55-7).
c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-55-28), and the entity has an enforceable right to payment for performance completed to date (see FASB ASC 606-10-55-29).

FinREC believes that each increment of asset management service (that is, each daily provision of service) is satisfied over time because the customer simultaneously receives and consumes the benefits of the advisory services in accordance with FASB ASC 606-10-25-27(a), as another entity would not need to substantially re-perform any of the services performed to date and the customer can benefit from each day of service on its own.

Measuring progress toward complete satisfaction of a performance obligation (FASB ASC 606-10-25-31 through 25-37*)*

For performance obligations satisfied over time, the entity must determine how to measure progress towards complete satisfaction of the performance obligation. FASB ASC 606-10-25-31 states that the objective when measuring progress is to depict the transfer of services to the customer (that is, the satisfaction of an entity's performance obligation).

FinREC believes that a time-based measure of progress should be applied when measuring progress toward complete satisfaction of the asset management services performance obligation (and hence for recognizing as revenue management fees). Consistent with FASB ASC 606-10-55-222 of Example 25, *Management Fees Subject to the Constraint*, asset management services constitute a single performance obligation pursuant to the series provision in FASB ASC 606-10-25-14(b) because not only is the asset manager providing a series of distinct services that are substantially the same (that is, daily asset management services), but those distinct services have the same pattern of transfer. Daily asset management services have the same pattern of transfer because (a) they are transferred to the customer over time, in accordance with FASB ASC 606-10-25-27 (see paragraph 25), and (b) use the same method to measure progress – a time-based measure of progress.

Entities should consider the guidance in FASB ASC 606-10-25-36 through 25-37, and then conclude whether their selected methodology is a reasonable measure of progress toward complete satisfaction of the performance obligation. As stated in FASB ASC 606-10-25-36, an entity should only recognize revenue for its performance if it can reasonably measure progress toward complete satisfaction of the performance obligation. Accordingly, the method used to measure progress should be based on reliable information.

Unitary management fee arrangements

23. Similar to a traditional management fee arrangement, a unitary management fee arrangement involves the asset manager performing asset management services as well as other services associated with operations of a fund. The main difference is that the asset manager also agrees to pay for certain specified operating services in exchange for the unitary fee. As explained below, the analysis above for management fees applies equally to unitary management fee arrangements; notable exceptions or additional analysis points are indicated.

24. A 'unitary fee' may also apply in other scenarios. For example, a single fee may only cover the provision of operating services. Alternatively, a single fee may cover investment advisory services and fund administration services, but not other related services such as custody and transfer agency services. Key to the evaluation of all unitary fee arrangements is the determination of the nature of the overall promise to the customer. Irrespective of how contracts are arranged, if a single fee is paid to an asset manager that covers more than one service, the asset manager must determine if the promise in the contract is to transfer to the customer either (a) each of the underlying services, or (b) a combined service to which the promised goods or services are inputs. Note that for some situations, an additional assessment on combination of contracts may be required. For purposes of this memo, the focus is on unitary management fee arrangements that include payment for investment advisory services as well as a number of operating services.

<u>Background - Unitary management fee arrangements</u>

25. Unitary investment management fees are generally asset-based fees received from certain managed funds, managed exchange-traded funds ("ETFs") and common collective trust funds ("CCTFs") for the provision of investment advisory as well as management and/or payment of certain specified other operational expenses. As with management fees, the unitary management fee is typically calculated as a percentage of gross or net assets at a point in time or the average of such assets over a given period (such as daily, monthly, or quarterly), and the billing terms of the fee (both timing (in arrears or in advance) and frequency) are included in a management agreement between the asset manager and the customer. The fund or unit trust is typically deemed to be the customer under Step 1 of the revenue recognition model.

26. Similar to management fee arrangements, in a unitary management fee arrangement, the asset manager is appointed as manager with all the powers, duties, and discretions exercisable in respect of the management of the fund or unit trust. As manager, they are typically responsible for ensuring the operation of the fund or unit trust, irrespective of who performs the services.

27. Under unitary management fee agreements, investors are aware that a single fee is being charged, that the fee is paid to the asset manager in its capacity as manager, and that the fee covers payment for certain operational expenses. Example operating services covered by the unitary management fee include but are not limited to administrative services such as on-going record keeping, custodianship of assets, transfer agency and registry services, regulatory filing, audit and tax advisory services, accounting services, printing, information services, and distribution services. Investors may be made aware of the identity of some appointed third-party service providers for certain delegated operating services because that information may be disclosed in the prospectus (for example, the administrator or custodian). Irrespective of whether the manager performs the operating services or delegates them, the services are all performed for and provide benefit to the fund or unit trust (that is, the customer) consistently over a given time period.

28. Notably, the same operating services that are covered by the unitary management fee are performed on behalf of the fund under management fee arrangements. As highlighted in paragraph 38, the main difference between these two types of arrangements is the entity that makes payment for operating expenses (that is, the asset manager versus the fund). The primary reason for having two types of 'payment arrangements' is the fund's ability to manage its cost. Under unitary fee management fee arrangements, the onus is on the asset manager to manage operating costs. They are responsible for any costs that cannot be covered by the unitary fee they receive as payment for managing the fund (that is, by the unitary management fee). Comparatively, under management fee arrangements, the fund is exposed to cost overruns, subject to limitations in the form of expense caps. Depending on facts and circumstances related to a given fund, shareholders may prefer one arrangement over the other.

29. Whether the unitary management fee revenue should be presented gross or net of the cost of outsourced operating services requires an analysis of the principal versus agent criteria in FASB ASC 606-10-55-36 through

55-40. Industry considerations relevant to evaluating presentation of unitary management fees are discussed within the issue 10-9 “Principal versus agent considerations” issue.

30. For purposes of the following analysis, assume that entitlement to and amount of the unitary management fee do not depend on the performance of the investments under management meeting specified investment return thresholds and that there is no associated clawback provision.

Example – unitary management fees

Identify the contract with a customer (FASB ASC 606-10-25-1 through 25-8)

Refer to the discussion of this step above under management fees. The same assessment applies to unitary management fee arrangements.

Identify separate performance obligations (FASB ASC 606-10-25-14 through 25-22)

FinREC believes that a similar assessment to that above for management fees applies to unitary management fee arrangements. The main difference being that under unitary management fee arrangements, the asset manager receives a higher management fee designed to encompass the additional costs associated with discharging payment to third-party service providers (this is typically explained in the fund governing documents). To the extent the cost of services provided by a third-party service provider exceeds the asset manager’s anticipated amount budgeted as part of its unitary management fee, such excess is paid out of the asset manager’s assets. In comparison, under a management fee contract, the fund typically *directly* pays the operating service costs. Nonetheless, the nature of the asset manager’s promise is the same in either instance. It is the promise to stand ready or provide a single service until the arrangement is terminated by either party or until the fund is dissolved, pursuant to contractual terms (also see discussion under management fees above). This additional service of discharging payment occurs concurrently with the traditional investment advisory services and has the same pattern of transfer, making the accounting evaluation similar to that above for management fees and consistent with Example 25, *Management Fees Subject to the Constraint*, FASB ASC 606-10-55-221 through 55-225.

Some of the operating services over which the asset manager is responsible for paying may be primarily performed during a particular time or times of the year, for example, audit and legal services and regulatory filing services. As well, payment for these services may only be made at these times. However, there are typically aspects of such services that are performed *throughout* the year, as other asset management-related services are performed.

When evaluating the nature of the promise to the customer, FinREC believes that if disclosure in the governing documents is made of the amount of the unitary fee attributable to each operating service covered by the unitary management fee, that this disclosure should *not* in and of itself dictate the identification of distinct goods or services.

Because the nature of the asset manager’s promise in a unitary fee arrangement is to provide day-to-day management of a fund, the promise involves the provision of a number of services that collectively represent the complete service promised to the customer. Underlying services may include investment advisory services, accounting services, preparing proxies, printing prospectuses, providing distribution services, and custodian and transfer agency services. All of these underlying activities could significantly vary within a day or from day to day; however, that is not relevant to the evaluation of the nature of the promise. In this regard, the nature of the contract is to provide integrated fund management services, inclusive of investment advisory services and certain operating services, as opposed to a specific quantity of specified services. Similar to management fee arrangements, FinREC believes that it is reasonable to conclude that each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day. The daily services are those activities that are required to satisfy the asset manager’s obligation to provide an integrated fund management service. FinREC believes that a similar assessment to that above for management fees applies in these instances.

Satisfaction of the performance obligations (FASB ASC 606-10-25-23 through 25-30); Measuring progress toward complete satisfaction of a performance obligation (FASB ASC 606-10-25-31 through 25-37*); Determining the transaction price (FASB ASC 606-10-32-2 through 32-4); Determining the transaction price—Variable consideration (FASB ASC 606-10-32-5 through 32-9); & Allocating the transaction price to performance obligations (FASB ASC 606-10-32-28 through 25-35)*

Refer to the discussion of this step above, under management fees. The same assessment applies to unitary management fee arrangements.

Comments should be received by August 1, 2017, and sent by electronic mail to Irina Portnoy at Irina.Portnoy@aicpa-cima.com, or you can send them by mail to Irina Portnoy, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.