Working Draft:

Asset Management Revenue Recognition Implementation Issue

Issue # 10-3: Management Fee Waivers and Customer Expense Reimbursements

Expected Overall Level of Impact to Industry Accounting:

Minimal

Wording to be Included in the Revenue Recognition Guide:

Background

1. Asset managers often charge asset-based fees in exchange for performing asset management services. These services are performed and provide benefit to the customer[1] consistently over a given time period (for example, daily, monthly, quarterly, semi-annually, or annually). The terms of the management fee, which is typically a percentage of gross or net assets or average gross or net assets over a given period (such as daily, monthly, or quarterly) or at a point in time, and the billing terms of the fee (generally monthly, quarterly, or semi-annually) are included in an investment management agreement ("IMA") between the asset manager and the customer. In accordance with FASB ASC 606-10-25-14(b) and consistent with Example 25 in FASB ASC 606 (FASB ASC 606-10-55-221 through 55-225), the promise in the IMA to provide asset management services is a single performance obligation. This is because the promise consists of a series of distinct services that are substantially the same and that have the same pattern of transfer to the customer (that is, transferred over time and generally performed daily). Considerations relevant to identifying separate performance obligations in IMAs are discussed in detail within issue 10-2 "Management Fee Revenue, excluding Performance Fee Revenue".

2. In certain instances, some asset managers may waive, or refrain from charging, a portion or all of the management fees for a certain period of time. Most fee waivers arise from one of two agreements by the asset manager: (a) to reduce a specified portion of management fees (referred to as "flat fee waivers"), or (b) to limit the total expense ratio that accrues to and is specific to a particular share class, typically expressed as a percentage of average daily net assets and referred to as an "expense cap". Expense caps are designed to limit the amount of expenses a shareholder experiences and can exist at a master fund level (in a master-feeder structure) or fund level, and are *specific to each share class*. They may be affected by reductions in fees and/or cash reimbursements of fees.

[1] In many fee waiver situations, the customer will be deemed to be the fund, based on considerations of the factors described within issue 10-X "Determining the Customer in an Asset Management Arrangement". Accordingly, reference will be made to the *fund* as the customer for purposes of this issue.

Comparatively, “flat” reductions of management fees apply to all share classes and are granted separate from expense caps. For purposes of this issue, unless stated otherwise, fee waivers and expense caps will collectively be referred to as “fee waivers”.

3. Fee waivers generally are legally enforceable and may not require a significant degree of judgment to interpret or involve uncertainty. Nonregistered funds may grant fee waivers and expense caps. However, such grants are not commonplace and are often granted for particular reasons, such as poor fund performance or to remain competitive (maintain clients). Investment companies registered under the Investment Company Act of 1940 (referred to as “registered funds” or “funds” for the purpose of this memo, unless otherwise indicated) may have either or both contractual and voluntary fee waivers, as described below.

4. Contractual fee waivers are typically documented in a fund’s prospectus. They may also be documented in an expense limitation agreement or similar type of contract that outlines the terms of all (or most) of the asset manager’s contractual fee waivers in existence at any given time. For example, this contract may detail the applicable expense limit for specified registrants, the method of computing the liability that the asset manager owes under the expense cap, year-end adjustment, applicable management or administration fee that is waived, or the conditions pursuant to which the asset manager has a right to claim reimbursement of previously waived/reduced fees and expenses reimbursed from specified share classes of specified portfolios.

5. Contractual fee waivers are generally[2] in place for a minimum of one year beginning on the filing date of the prospectus and are renewed or approved by the fund’s board annually in conjunction with the filing of the prospectus. They are commonly implemented at fund launch. In comparison, voluntary fee waivers do not require approval of the fund’s board, have no minimum time period, can be discontinued at any time by the asset manager, and may be less transparent to new shareholders because they may not be reflected in the prospectus fee table or footnote.

6. “Flat” fee waivers may be stated in terms of a fixed amount or may be variable (for example, calculated as a certain number of basis points applied to the daily average asset value). Expense caps tend to be stated in terms of a percentage of the value of assets under management or AUM. Any number of reasons may cause an asset manager to grant a fee waiver including market factors (for example, competition), interest in attracting or retaining investors, addressing a client’s dissatisfaction in service (for example, customer goodwill), or service disruptions, among others. Asset managers typically do not receive any distinct goods or services from the customer for providing fee waivers. This is assumed to be the case for purposes of this issue.

7. As indicated above, some asset managers may agree to limit the amount of certain operating expenses incurred by shareholders (that is, expense caps). Expense caps reduce the fund’s expense ratio because the asset manager agrees to either (a) reduce the amount of management or administration fees due them from the specific share class, or (b) provide a cash reimbursement of certain operating expenses. Expense caps involve a more complex implementation process than “flat” fee waivers. They often involve a specific ordering of reductions in fees and fee reimbursements to achieve the contractual or voluntary expense cap. The sequence in which fees are reduced or reimbursed begins by evaluating the particular expenses related to the share class to which the expense cap applies. If those expenses pertain to fees paid to the asset manager (for example, for administration, advisory, or call center services), they are waived to the extent applicable based on the expense cap. To the extent they pertain to fees paid to external vendors (for example, for transfer agency, networking, and other operating expenses), the asset manager may reimburse such amounts to the fund or may make payment directly to the third-party vendor. If still more waivers or reimbursements are required in order to support the expense cap, then *fund level* expenses are reviewed for possible reduction or reimbursement. Additional waivers or reimbursements are required when class level expenses for the given period have been reduced to zero (through class level fee waiver) and the expense cap (which is share class specific) has not yet been achieved. Other expenses, those incurred at the fund level on behalf of shareholders of all classes, must therefore be reduced or reimbursed. Expenses that are waived or reimbursed at the fund level benefit shareholders in *all* share classes (that is, share classes that are not subject to the particular expense cap will benefit as well from the incremental reduction in fees or reimbursement).

8. To the extent that fee waivers exceed the gross management fee payable to the asset managers for a given performance period, the asset manager normally will not receive any fees and will instead pay the excess amount to the fund. Conversely, if the cumulative daily fee waivers or expense reimbursements exceed the fund’s final calculated fee waiver or expense cap, respectively, the asset manager may be able to claim a refund depending on the terms of the given fee waiver. Notably, these adjustments tend to be immaterial because throughout the year (a) there is generally only a one-month lag in obtaining expense information from a fund for any days of a given month that the asset manager must estimate due to its internal reporting process, and (b) an asset manager

[2] In order to be included in the prospectus, these fee waivers must be in place for a minimum of one year.

often has “actual” data for most if not all days of each month (for example, for the first 25 days of each month), depending on internal reporting requirements. Therefore, based on the internal accounting cut-off date for reporting purposes, either (a) no estimation is required because monthly reporting is conducted early in the following month, or (b) only limited estimation is required for a few days each month (that is, by extrapolation from the actuals data) because the internal reporting cut-off date is a few days prior to month-end.

9. The accounting treatment of fee waivers is impacted by the following factors:
    a. Timing of execution relative to fund/account establishment or IMA renewal.
    b. Timing of execution relative to services rendered (that is, before or after).
    c. Whether they pertain to a “flat” fee waiver or to an expense cap.

10. For purposes of this section of the chapter, fee waivers are classified in one of three categories as described in the following table.

Table 1

Category	Timing of Execution Vs. Fund/Account Establishment or Contract[3] Renewal	Timing of Execution Vs. Services Rendered	“Flat” Fee Waiver (“FFW”) And/Or Expense Cap (“EC”)
1	Concurrent with Fund/Account Establishment or Contract Renewal	Before	FFW & EC
2	NOT Concurrent with Fund/Account Establishment or Contract Renewal	Before	FFW & EC
3	NOT Concurrent with Fund/Account Establishment or Contract Renewal	After (no future service required)	FFW

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

11. Industry considerations relevant to the determination of the customer and identification of the contract with the customer are discussed in detail within issues 10-1 “Determining the Customer in an Asset Management Arrangement” and 10-8 “Identifying the Contract” issues in this chapter. 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 costs. The evaluation of contract modifications is addressed in paragraphs 12 through 17 below.

Contract modifications (FASB ASC 606-10-25-10 through 25-13)

12. FinREC believes that the guidance on contract modifications applies to fee waivers that are not executed concurrently with fund/account establishment or renewal of a contract (i.e., Fee Waivers in Categories 2 and 3), because these fee waivers change existing enforceable rights and obligations of the parties to the original contract. While there is typically not a change in the scope of services to be performed under the related contract, the fee waiver represents an agreed-upon change in the transaction price.

13. If these fee waivers are subsequently renewed concurrent with renewal of the related contract, then contract modification guidance will not apply. Instead, in those situations, consideration must be given to other provisions

[3] The reference to a contract is intended to be general. The term “contract” is intended to reference the applicable legal document in which the responsibilities, authority, and obligations of the asset manager are described and agreed upon. Accordingly, a contract may take such forms as, but not limited to: an investment management agreement (“IMA”), a Declaration of Trust, Trust Deed, Investment Advisory Agreement, Management Agreement, Management Company Agreement, or Limited Partnership Agreement. This is described in more detail within issue 10-8 “Identifying the Contract”.

within Topic 606; specifically, refer to the discussion below on Category 1 fee waivers and applicability of the guidance on combination of contracts.

Category 2 fee waivers

14. The contract modification guidance in FASB ASC 606-10-25-13(a) applies, because the remaining services to which the fee waiver pertains are distinct from services transferred before the date of the contract modification. As explained below under *Identify performance obligations*, the promise to provide asset management services is a single performance obligation that represents a series of distinct services, pursuant to the guidance in FASB ASC 606-10-25-14(b). Basis for Conclusions paragraph BC79, supports application of FASB ASC 606-10-25-13(a) to this type of single performance obligation, i.e., a single performance obligation that represents a series of distinct goods or services. In applying FASB ASC 606-10-25-13(a), FinREC believes that Category 2 fee waivers are accounted for as if they were a termination of the existing contract, and the creation of a new contract. The amount of these fee waivers is therefore allocated to the remaining distinct services within the single performance obligation.

15. If the customer's right to the fee waiver is linked to payment of future management fees, then the asset manager must continue to transfer asset management services to the customer to generate the management fees against which the fee waiver will be applied. As such, the fee waiver relates to the promise to provide future asset management services. This may be the case when a fee waiver states that it will *only* be provided *if* the customer continues to engage the asset manager under the IMA and, if the customer terminates their contract with the asset manager, they will forfeit their right to any fee waiver not yet provided.

Category 3 fee waivers

16. The contract modification guidance in FASB ASC 606-10-25-13(b) applies, because the remaining services *to which the fee waiver pertains* are not distinct from services transferred before the date of the contract modification. In fact, there are no remaining services to be performed related to the fee waiver. Accordingly, the transaction price and the asset manager's measure of progress toward complete satisfaction of the performance obligation are updated to reflect the amount of the fee waiver as of the contract modification date. That is, the adjustment to revenue is made on a cumulative catch-up basis on the date of contract modification. This adjustment to revenue should be recognized at the date of contract modification even if payment of the fee waiver is linked to payment of future management fees, provided the asset manager is obligated as of that date to pay/ remit the full amount (i.e., the fee waiver is not subject to forfeiture). For further discussion, see situation (b) in the following paragraph.

17. If the customer's right to the fee waiver is *not* linked to payment of future management fees, then the asset manager is not required to continue to transfer asset management services to the customer to generate the management fees against which the fee waiver will be applied. As such, the fee waiver relates to the promise to provide *past* asset management services. This may be the case, but not limited to, when (a) the fee waiver is granted in full upon its execution, or (b) when a fee waiver is provided over a specified period of time and entitles the customer to a catch-up adjustment for any amount of the fee waiver not yet paid if and when they terminate their contract with the asset manager or the fund prior to the end of the fee waiver period.

Identify the contract with a customer—Combination of contracts (FASB ASC 606-10-25-9)

18. FinREC believes that the guidance on combination of contracts applies to fee waivers that are executed concurrent with fund/account establishment or renewal of a contract (Category 1). As explained in the "Identifying the Contract" issue, in certain instances, two or more separate contracts must be evaluated collectively for purposes of applying FASB ASC 606.

19. Based on the contract combination guidance in FASB ASC 606-10-25-9, FinREC believes the contract[4] and fee waiver would collectively be considered a single contract. The contracts are entered into at or near the same time with the same customer and the amount of consideration to be paid in one contract (the fee waiver) depends on the price and/or performance of services rendered under the other contract (for example, the IMA). For example, a fee waiver may provide for a reduction in management fees in the amount of 0.20 percent per annum of daily average asset value for the remaining performance period as and when management services are rendered.

[4] The reference to a contract is intended to be general. The term "contract" is intended to reference the applicable legal document in which the responsibilities, authority, and obligations of the asset manager are described and agreed upon. Accordingly, a contract may take such forms as, but not limited to: an investment management agreement ("IMA"), a Declaration of Trust, Trust Deed, Investment Advisory Agreement, Management Agreement, Management Company Agreement, or Limited Partnership Agreement. This is described in more detail within issue 10-8 "Identifying the Contract".

20. Upon concluding that the fee waiver should be combined with the related contract, the fee waiver, management fees, and any other forms of consideration per the contract (for example, performance fees), should be evaluated as components of the transaction price to which the asset manager expects to be entitled in exchange for transferring promised services to the customer under the contract.

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

21. As explained within issue 10-2 "Management Fee Revenue, excluding Performance Fee Revenue" , the promise to provide asset management services represents a single performance obligation based on application of the series guidance in FASB ASC 606-10-25-14(b) and related paragraphs.

22. The aforementioned guidance as well as that included in FASB ASC 606-10-25-19 on identifying performance obligations applies to the service contract that underlies all fee waivers (irrespective of fee waiver category). Fee waivers are not *in and of themselves* promises to transfer control over goods or services to the customer, nor are they payments for distinct goods or services from the customer. Instead, they generally represent a transaction price adjustment under FASB ASC 606-10-32-36, whether affected through a contract modification or an agreed-upon upfront reduction in management fees.

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

23. Considerations for evaluating the amount of management fees and performance fees to include in the transaction price are discussed in detail within issues 10-2 "Management Fee Revenue, excluding Performance Fee Revenue" and 10-5 "Incentive or Performance Fee Revenue, excluding incentive-based capital allocations". The following discussion provides considerations specific to Fee Waivers in Categories 1 and 2.

Determining the transaction price—Variable consideration and consideration payable to a customer (FASB ASC 606-10-32-5 through 32-9; FASB ASC 606-10-32-25 through 32-27)

24. Generally, for Fee Waivers in Categories 1 and 2 as of their respective effective date, the guidance on both consideration payable to a customer and variable consideration must be contemplated. Both sets of guidance apply because the Fee Waivers: (a) represent payment to the customer (generally in the form of a billing adjustment or cash reimbursement), and (b) are variable in amount (that is, subject to an underlying variable factor and/or subject to the continued provision of asset management services). According to FASB ASC 606-10-32-25, if consideration payable to a customer *includes a variable amount*, an entity must estimate the transaction price in accordance with the guidance on variable consideration. The guidance on variable consideration requires that an estimate of the amount to include in the transaction price be determined by using one of the following two methods depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:
    a. The expected value of the contract determined by the sum of probability-weighted amounts in a range of possible consideration amounts.
    b. The most likely amount equal to the single most likely amount in a range of possible consideration amounts.
25. The estimated amount of variable consideration that is included in the transaction price must be updated each reporting period along with a re-evaluation of the applicability of the guidance on constraining estimates of variable consideration. FinREC believes that the expected value method (sum of probability weighted amounts) will best predict the amount of base management fees that the asset manager will be entitled to given the large number of possible consideration amounts and limited predictive value of the asset manager's experience with similar types of fee waivers, as discussed in FASB ASC 606-10-32-8.

26. However, variable consideration can only be included in the transaction price to the extent it is not subject to the constraint. See the following discussion under *Constraining the Cumulative Amount of Revenue Recognized* for further discussion.

27. In applying the variable consideration guidance to Fee Waivers in Categories 2 and 3, an additional timing consideration applies. That is, the asset manager must determine whether this guidance applies prior to the granting of the fee waiver, i.e., prior to the effective date of the contract modification (as opposed to as of the date of contract modification). Such would be the case when an implicit price concession exists because negotiations of a fee waiver are well underway as of the end of the reporting period (with anticipated resolution in the near term) and/or the customer has a valid expectation as of the end of a reporting period that a Fee Waiver will be granted based on the entity's customary business practices, published policies, or specific statements.

Constraining the cumulative amount of revenue recognized (FASB ASC 606-10-32-11 through 32-13)

28. The transaction price for the performance obligation to which Fee Waivers relate (namely those in Categories 1 and 2, which relate to the promise to provide asset management services on a go-forward basis), should include an amount of variable consideration estimated in accordance with FASB ASC 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. For Fee Waivers with a fixed amount (a “fixed Fee Waiver”), this typically means that the transaction price will reflect the entire amount of the Fee Waiver upon its effective date, or earlier if the asset manager believes that there is implicit Fee Waiver as discussed in paragraph 27.

29. Comparatively, non-fixed Fee Waivers require evaluation of the factors listed in FASB ASC 606-10-32-12 to determine whether a portion or all of the amount estimated in accordance with FASB ASC 606-10-32-9 is restricted from inclusion in the transaction price until the underlying contingency is resolved. Non-fixed Fee Waivers are often calculated by applying a specified rate (basis points) to a measure of AUM (for example, daily average net AUM); thereby, their element of variability is the associated AUM, which can vary each day. Resolution of this underlying contingency (typically, the associated AUM) occurs when the measure of AUM (or other variable factor) on which the Fee Waivers are calculated becomes fixed. FinREC believes that the constraint guidance will often apply to non-fixed Fee Waivers because AUM is dependent on the market and thus is highly susceptible to factors outside the asset manager’s influence. In addition, non-fixed Fee Waivers typically have a large number and broad range of possible consideration amounts. Further, although the asset manager may have experience with similar contracts, that historical experience is typically of little predictive value in determining the future performance of the market or the asset manager’s intent on issuing additional similar Fee Waivers in the future.

30. Another consideration when evaluating the amount of Fee Waiver to reflect in the transaction price is that the amount to reflect may need to be greater than the estimated amount of the Fee Waiver as determined in accordance with FASB 606-10-32-5 through 32-9, due to broader macroeconomic events. Consider the situation described in the following paragraphs.

31. If the amount of AUM significantly declines for a given reporting period, the amount of the associated fee waiver may significantly increase and could potentially result in repayment of management fees, specifically in the case of expense caps. As explained above, expense caps (a) are generally written in terms of a percentage of average daily net assets, on an annual basis, and, (b) as with “flat” Fee Waivers, are subject to the guidance on constraining estimates of variable consideration. Accordingly, if AUM significantly declines, the quantified dollar amount of the expense cap (calculated based on the contractual percentage of average daily net assets) could be significantly lowered. In these instances, therefore, it would be easier for the expense cap to be met and for a greater amount of operating expenses to exceed the expense cap; hence, a larger fee waiver would need to be provided. As such, the asset manager may not be able to conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized to-date will not occur. When the amount of promised consideration from the customer, including management fees, is highly susceptible to external factors (such as the potential for fluctuations in net assets arising from market changes and unpredictable shareholder activity), the recognition of revenue may be constrained in accordance with paragraphs 11 -12 of FASB ASC 606-10-32.

32. Although the variable consideration may be constrained when an expense cap exists, the constraint would most likely have a material impact on the recognition of revenue when the asset manager believes that the net assets might fluctuate significantly during the current period. Factors to consider include:
    a. Stability of the net assets (that is, if the fund has reached critical mass).
    b. Susceptibility to significant investor subscription and redemption activity.
    c. Investment objective of the fund or portfolio relative to market conditions and macroeconomic events and history of instability or uncertainty, resulting in volatile investment valuations.

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

33. Since Fee Waivers typically pertain to an asset management service performance obligation that (a) is satisfied over time, (b) represents a series of distinct services in accordance with FASB ASC 505-10-25-14(b), and (c) is provided in exchange for variable consideration in the form of management fees, considerations relevant to the allocation of variable consideration apply. These considerations are discussed in detail within issue 10-2 “Management Fee Revenue, excluding Performance Fee Revenue”.

Satisfaction of the performance obligations (FASB ASC 606-10-25-23 through 25-32)—Contracts entered at or near the same time

34. For all fee waivers, satisfaction of the corresponding performance obligation to provide asset management services must be assessed. As described above, fee waivers do not represent distinct performance obligations

themselves, but rather an adjustment to the transaction price allocated to a related performance obligation by representing: (a) a component of transaction price as of fund/account establishment or contract renewal (Category 1), (b) a component of transaction price as of contract modification date (Category 2), and/or (c) a change in price of a contract that is affected by a contract modification (Categories 2 and 3). Considerations related to evaluating satisfaction of a performance obligation to provide asset management services are discussed in detail within issue 10-2 "Management Fee Revenue, excluding Performance Fee Revenue".

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

35. Since all fee waivers pertain to a performance obligation to provide asset management services and that performance obligation is satisfied over time, considerations relevant to measuring progress toward complete satisfaction of this performance obligation apply. These considerations are discussed in detail within issue 10-2 "Management Fee Revenue, excluding Performance Fee Revenue".

36. The examples in this section are meant for illustrative purposes only and are not intended to be all-inclusive. They highlight application of key concepts discussed in this chapter as they relate to the three categories of Fee Waivers defined herein. Consideration should be given to all relevant facts and circumstances of an entity's situation. Certain aspects of the points raised for assessment in the examples may apply to a greater or lesser extent to an entity's own situation, as required by the given facts and circumstances.

Example 1 demonstrates the interaction between the guidance on variable consideration and contract modifications.

Example 1 [Category 2 – *"Flat" Fee Waivers*]: An asset manager launched a new mutual fund and did not concurrently agree to provide a fee waiver or expense cap. The fund's prospectus established the management fees for the fund's three share classes, which ranges from 30 basis points (bps) to 45bps per annum. Over the following year, certain regulations were changed such that it became easier for similar funds to be launched by foreign asset managers. Upon identifying a number of new products entering the market similar to its own while performing its ongoing, regular market trend analysis, the asset manager undertook a competitor analysis and determined that it should reduce its fees on all of its share classes (at least temporarily) to remain competitive. This fee waiver was implemented mid-year and not concurrent with the annual issuance of its prospectus. The fee waiver is expected to be applied for the foreseeable future at the asset manager's sole discretion.

In accounting for the fee waiver, the asset manager determines that the guidance on contract modifications in FASB ASC 606-10-25-10 through 25-13 applies. In particular, FASB ASC 606-10-25-13 sub-paragraph (a) is the appropriate guidance because the remaining services to be performed by the asset manager under its IMA with the mutual fund is distinct from services previously rendered. Before finalizing this assessment, the asset manager also considers whether the variable consideration guidance applies and hence an estimate of the fee waiver should be included in the transaction price *prior* to the effective date of the contract modification. In this regard, the asset manager determines that it has insufficient history of fee waivers granted by this mutual fund, that the impetus behind fee waivers granted for other mutual funds were primarily driven by unique market events and conditions and hence have limited predictive value, and that its customary business practices, published policies and statements are not sufficient to create a valid expectation of the customer that the entity will accept an amount of consideration that is less than the stated management fee in the IMA. In summary, until completion of the competitor analysis and management sign-off of a voluntary fee waiver, the asset manager concludes that the fee waiver should not be reflected in the transaction price.

The asset manager will treat the fee waiver as a reduction of the transaction price (and hence of revenue), because the billing adjustment represents consideration payable to the customer and the asset manager is not receiving a distinct good or service from the customer in exchange. When determining when to reflect the fee waiver in the transaction price (and hence in revenue), the asset manager considers the factors in FASB ASC 606-10-32-12 because the fee waiver does not have a fixed amount. Instead, the amount of the fee waiver is calculated by applying a specified number of basis points to average daily AUM. Accordingly, based on the asset manager's assessment and as outlined in paragraph 29, only the daily calculated amount of the fee waiver is reflected in the transaction price each day, post-effective date of the fee waiver.

Example 2 illustrates application of the guidance on the combination of contracts.

Example 2 [Category 1 – *"Flat" Fee Waiver*]: An asset manager agrees to manage a fund pursuant to an IMA with a stated management fee at the annual rate of 1 percent of the fund's daily average net assets. Concurrently, the asset manager agrees to waive a flat (non-variable) 0.20 percent of daily average net assets for a one-year period, subject to annual renewal. Since the two agreements are entered into with the same customer, the asset manager considers the guidance on combining contracts in FASB ASC 606-10-25-9 when determining its accounting for the fee waiver. The asset manager concludes that the IMA and fee waiver agreement (documented in the fund's prospectus) meet the two conditions in FASB ASC 606-10-25-9 to be evaluated collectively under Topic 606, because they are entered into at or near the same time with the same customer and have a single commercial objective.

In applying Topic 606 to the combined contract, the asset manager determines that both the management fee and fee waiver pertain to the same performance obligation, to provide asset management services for the customer. That is, they are both components of consideration promised by the customer for a single promised service. Accordingly, the asset manager concludes that the transaction price (and hence revenue) should be determined on a go-forward basis by applying an annualized percentage of 0.80, i.e., the annual management fee of 1 percent *less* the fee waiver of 0.20 percent, to the fund's daily average net asset value.

The asset manager will treat the fee waiver as a reduction of the transaction price (and hence of revenue), because the billing adjustment represents consideration payable to the customer and the asset manager is not receiving a distinct good or service from the customer in exchange. When determining when to reflect the fee waiver in the transaction price (and hence in revenue), the asset manager considers the factors in FASB ASC 606-10-32-12 because the fee waiver does not have a fixed amount. Instead, the amount of the fee waiver is calculated by applying a specified number of basis points to average daily AUM. Accordingly, based on the asset manager's assessment and as outlined in paragraph 29, only the daily calculated amount of the fee waiver is reflected in the transaction price each day, post-effective date of the fee waiver.

Examples 3 and 4 demonstrate the analysis involved in determining when and in what amount fee waivers should be included in the transaction price. The following information applies to both examples:

Background

The asset manager manages a fund for which it is entitled to a management fee at the annual rate of 1 percent of the fund's average daily net assets. Upon launching the fund, the asset manager concurrently agrees to an expense cap for the fund's single share class, to help attract investors while the fund is in its growth phase to get up to scale. The expense cap contractually limits specified fund operating expenses to 1.20 percent of daily average net asset value on an annualized basis. To determine the quantified dollar amount of an expense cap for any given day, the mutual fund calculates the operating expenses incurred year-to-date as a percentage of year-to-date daily average net asset value. This percentage is then annualized and compared to the 1.20 percent agreed-upon expense cap. If the ratio is greater than 1.20 percent, the asset manager will reduce its management and administrative fees and/or reimburse the fund for all or a portion of the excess, based on the specific order of expense waivers and reimbursements to achieve this particular expense cap.

<u>Example 3 [Category 1 – *Expense Cap*]</u>: For a given day during the current period, the expense cap ratio is determined to be 1.25 percent. Based on the specific order of expense waivers/reimbursement to achieve the share class's expense cap, the difference is first required to be satisfied by a reduction in the asset manager's management and administrative fees. After reducing those fees to zero, a portion of that difference remains to be supported. The asset manager satisfies this remaining amount with a cash reimbursement to the fund, which relates to fees paid to external vendors.

The asset manager will treat the expense cap, whether affected by the fee waiver or cash reimbursement, as a reduction of the transaction price (and hence of revenue), because the billing adjustment and payment represents consideration payable to the customer and the asset manager is not receiving a distinct good or service from the customer in exchange. When determining when to reflect the expense cap in the transaction price (and hence in revenue), the asset manager considers the factors in FASB ASC 606-10-32-12 because the expense cap does not have a fixed amount. Instead, the amount of the expense cap is calculated by applying a specified number of basis points to annual AUM (calculated based on average daily AUM to operationalize). Accordingly, based on the asset manager's assessment and as outlined in paragraph 29, only the daily calculated amount of the expense cap is reflected in the transaction price each day, post-effective date of the expense cap.

<u>Example 4 [Category 1 – *Expense Cap and "Flat" Fee Waiver*]</u>: In addition to the expense cap, the asset manager agrees to a flat (non-variable) fee waiver of 0.20 percent per annum. As of a given day, the mutual fund estimates that annualized expenses to-date are 1.23 percent. As a result, the asset manager records revenue at the rate of a net annualized management fee of 0.77 percent. This rate is determined by subtracting from the annualized management fee of 1 percent: (a) the 0.20 percent annualized fee waiver, and (b) the annualized expense cap of 0.03 percent.

The asset manager observes that depending on continued AUM volatility, its management fee may need to be constrained further from recognition in the current period, i.e., below the net annualized rate of 0.77 percent. At each subsequent reporting date, the asset manager will need to determine whether any additional portion of the consideration should be constrained from inclusion in the transaction price (and hence in revenue). The asset manager must use judgment in determining the amount of transaction price (and hence revenue) that is limited by the revenue constraint discussed in FASB ASC 606-10-32-11 through 32-13.

The asset manager will treat the expense cap and fee waiver as a reduction of the transaction price (and hence of revenue), because the related billing adjustments represent consideration payable to the customer and the asset manager is not receiving a distinct good or service from the customer in exchange. When determining when to reflect the expense cap and fee waiver in the transaction price (and hence in revenue), the asset manager considers the factors in FASB ASC 606-10-32-12 because neither the expense cap nor the fee waiver has a fixed amount. Instead, the amount of both the expense cap and the fee waiver is calculated by applying a specified number of basis points to average daily AUM. Accordingly, based on the asset manager's assessment and as outlined in paragraph 29, only the daily calculated amount of the expense cap and fee waiver is reflected in the transaction price each day, post-effective date of the expense cap and fee waiver.

Examples 5 and 6 illustrate the importance of identifying the period to which the Fee Waiver applies, to past services rendered or to future services yet to be provided.

<u>Example 5 [Category 2 – *"Flat" Fee Waiver*]</u>: An asset manager agrees to provide a fee waiver to a customer as a goodwill gesture, to help cover costs they recently incurred as a result of the asset manager's actions. Specifically, due to an internal reorganization, the fund's management team and investment guidelines were changed, which required the customer to incur certain costs in making the necessary legal agreement transfers. The asset manager agrees to reduce its management fees by a specified amount over the next four quarters. The customer is entitled to the fee waiver for as long as it remains a client of the asset manager over that period of time. If the customer terminates its contract with the asset manager prior to the end of the four quarters, they forfeit any unpaid fee waiver.

Similar to Example 1, in accounting for the fee waiver, the asset manager determines that the guidance on contract modifications in FASB ASC 606-10-25-10 through 25-13 applies. Also akin to Example 1, the asset manager determines that FASB ASC 606-10-25-13(a) is the specifically applicable guidance because the remaining services to be performed by the asset manager under its IMA with the mutual fund are distinct from services previously rendered. While the motivation for providing the fee waiver is a past incident, the fact that future reductions in billings depend on the asset manager continuing to perform asset management services under the IMA supports the fee waiver's relevance to its promise to provide *future* asset management services.

The asset manager also considers whether the fee waiver is subject to the variable consideration guidance and if so when. In this regard, the asset manager determines that the fee waiver is a form of variable consideration (it does not have a fixed amount); the amount of the fee waiver is calculated by applying a specified number of basis points to average daily AUM. Then, consideration is given to whether this form of price concession should be included in the transaction price *prior* to or *as of* the effective date of the contract modification. The asset manager observes that it has insufficient history of fee waivers granted by this mutual fund, that the impetus behind fee waivers granted for other mutual funds were primarily driven by unique market events and conditions and hence have limited predictive value, and that its customary business practices, published policies and statements are not sufficient to create a valid expectation of the customer that the entity will accept an amount of consideration that is less than the stated management fee in the IMA. Given these factors, the asset manager concludes that until management approves the voluntary fee waiver and the waiver becomes effective, the fee waiver should not be considered for inclusion in the transaction price because there is no implicit price concession as described in FASB ASC 606-10-32-7. Once the fee waiver is effective, the asset manager evaluates the factors in FASB ASC 606-10-32-12. Based on the asset manager's assessment of this guidance and in accordance with the framework in paragraph 29, only the daily calculated amount of the fee waiver is includible in the transaction price each day post-effective date of the fee waiver.

The asset manager will treat the fee waiver as a reduction of the transaction price (and hence of revenue), because the billing adjustment represents consideration payable to the customer and the asset manager is not receiving a distinct good or service from the customer in exchange.

<u>Example 6 [Category 3 – *"Flat" Fee Waiver*]</u>: The same facts as in Example 5 apply, except that the customer does <u>not</u> forfeit any unpaid fee waiver should they terminate their contract with the asset manager prior to the end of the fee waiver payout period. The asset manager is obligated upon grant date to provide the fee waiver in full. Therefore, should the customer's contract be terminated prior to the full year, any unpaid fee waiver will become due and payable to the customer at that time.

Similar to Examples 1 and 5, in accounting for the fee waiver, the asset manager determines that the guidance on contract modifications in FASB ASC 606-10-25-10 through 25-13 applies. However, dissimilar to the prior examples, the asset manager determines that FASB ASC 606-10-25-13(b) is the specifically applicable guidance because the remaining services to which the fee waiver pertains are not distinct from services transferred before the date of the contract modification. In fact, there are no remaining services to be performed in order for the customer to be entitled to the fee waiver. Accordingly, the transaction price and the asset manager's measure of progress toward complete satisfaction of the performance obligation are updated to reflect the amount of the fee waiver as of the contract modification date.

The asset manager also considers whether the fee waiver is subject to the variable consideration guidance and if so when. In this regard, the asset manager determines that the fee waiver is a form of variable consideration (it does not have a fixed amount); the amount of the fee waiver is calculated by applying a specified number of basis points to average daily AUM. Then, consideration is given to whether this form of price concession should be included in the transaction price *prior* to or *as of* the effective date of the contract modification. The asset manager observes that it has insufficient history of fee waivers granted by this mutual fund, that the impetus behind fee waivers granted for other mutual funds were primarily driven by unique market events and conditions and hence have limited predictive value, and that its customary business practices, published policies and statements are not sufficient to create a valid expectation of the customer that the entity will accept an amount of consideration that is less than the stated management fee in the IMA. Given these factors, the asset manager concludes that until management approves the voluntary fee waiver and the waiver becomes effective, the fee waiver should not be considered for inclusion in the transaction price because there is no implicit price concession as described in FASB ASC 606-10-32-7. Once the fee waiver is effective, the asset manager evaluates the factors in FASB ASC 606-10-32-12. Based on the asset manager's assessment of this guidance and in accordance with the framework in paragraph 29, only the daily calculated amount of the fee waiver is includible in the transaction price each day post-effective date of the fee waiver

The asset manager will treat the billing adjustment as a reduction of the transaction price (and hence of revenue), because the payment represents consideration payable to the customer and the asset manager is not receiving a distinct good or service from the customer in exchange. However, unlike in the prior examples, the fee waiver <u>in its entirety</u> will be reflected as a reduction in revenue as well upon grant date because (a) there are no remaining contingencies that restrict inclusion of the full amount in the transaction price (i.e., the asset manager is obligated in full to provide the fee waiver as of this date and the amount is known), and (b) the asset manager is not required to perform future services. Whether and when the customer subsequently terminates its contract with the asset manager has no implication on the asset manager's obligation to provide the fee waiver as of grant date or the amount of the fee waiver owed to the customer.

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.