Working Draft:

Asset Management Revenue Recognition Implementation Issue

Issue # 10-5A: Incentive-Based Capital Allocations.

Expected Overall Level of Impact to Industry Accounting:
Significant

Wording to be Included in the Revenue Recognition Guide:

Background

1. Incentive-based capital allocations, including carried interest, are arrangements where a performance fee is allocated to an asset manager or its affiliate (collectively, the “asset manager”) through a re-allocation of net earnings from the capital accounts of the non-managing interest holders to the asset manager’s capital account when returns exceed contractual thresholds.

2. Unlike typical performance fees, which may be calculated by applying fixed contractual basis points to assets under management, incentive-based capital allocations are based on a contractual methodology to determine the allocated share of profits. For example, incentive-based capital allocations may be based on a percentage of the investment company’s[1] net proceeds from the sale of an investment or on a percentage of net proceeds in excess of a specific profit benchmark. For a discussion on incentive or performance fees (collectively, “performance fee”) that do not involve a re-allocation of profits, refer to Issue 10-5: “Incentive or Performance Fee Revenue, excluding incentive-based capital allocations (such as carried interest)”.

3. Incentive-based capital allocations may also include clawback or other similar provisions that allow the investment company to look-back and confirm performance, which could affect the timing of distributions or require repayment of previously distributed amounts. Clawback provisions require the return of all or a portion of previously distributed incentive-based capital allocations made to the asset manager if contractually-specified conditions are not met (e.g., declines in the performance of the underlying portfolio).

[1] While the term ‘investment company’ is used throughout, capital-based incentive allocations may apply to a variety of products offered by asset managers (for example, real estate investment trusts) that may not be within the definition of an investment company under FASB ASC Topic 946. The interpretations in this issue may be applicable to those products, based on facts and circumstances.

4. At the April 2016 meeting of the FASB/IASB Revenue Recognition Transition Resource Group (TRG), TRG members considered whether incentive-based capital allocations, such as carried interest, are within the scope of FASB ASC Topic 606. As discussed in paragraphs 6 through 10 of TRG Agenda Ref No. 55: April 2016 Meeting – Summary of Issues Discussed and Next Steps:

> 6. Some entities, particularly asset managers, receive incentive-based performance fees via an allocation of capital from an investment fund under management (that is, through a "carried interest"). The fees are provided to compensate the asset manager for its services and performance in managing the fund. Many stakeholders think there are two aspects to those incentive-based fee arrangements: (a) compensation for asset management services and (b) financial exposure to the fund's performance. Stakeholders have raised questions about whether those arrangements are within the scope of Topic 606 or, instead, are in the scope of other GAAP, such as Topic 323, Investments-Equity Method and Joint Ventures, which is listed as a scope exception in paragraph 606-10-15-2(c)(3).
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> 7. All seven FASB Board members were present at the TRG meeting and each stated their views that those arrangements are within the scope of Topic 606. Board members highlighted that:
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> > (a) On various occasions during development of the new revenue standard, the FASB and the IASB discussed how the new revenue recognition guidance would apply to asset management contracts. The topic was discussed during public joint Board meetings on September 24, 2012, November 19, 2012, and January 30, 2013. At the January 30, 2013 joint Board meeting, the Boards confirmed their proposal in the 2011 Exposure Draft that an asset manager's performance-based incentive fees are subject to the constraint on variable consideration.
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> > (b) Example 25 of Update 2014-09 illustrates the application of the variable consideration constraint guidance to an asset manager contract. Although Example 25 is not explicit about whether the guidance applies to fee arrangements in which the asset manager is compensated for performance-based fees via an interest, such as a carried interest, the Board's view is that this example illustrates the intent that performance-based fees are in the scope of Topic 606.
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> > (c) A few Board members highlighted a potential inconsistency in feedback received from some stakeholders about the nature of carried interest during the outreach phase of ASU 2015-02, *Consolidation (Topic 810)—Amendments to the Consolidation Analysis*, and during the implementation phase of the new revenue standard. In outreach for the project leading to Update 2015-02, some stakeholders asserted that carried interest is a fee for services and, therefore, it should not be considered a variable interest under the consolidation guidance. This assertion seems inconsistent with a view that carried interest is an equity interest for the purposes of determining whether the contracts are within the scope of Topic 606. Several Board members also stated their belief that if the arrangements are considered equity interests outside the scope of Topic 606, an entity would need to evaluate the effect of that conclusion on its consolidation analysis under Topic 810, Consolidation.
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> 8. Many TRG members agreed that the arrangements are within the scope of Topic 606. A few TRG members stated that they can understand a view that carried interest could be considered an equity arrangement, because it is, in form, an interest in the entity. Some TRG members stated that if the arrangements are considered equity interests outside the scope of Topic 606, then questions could arise in practice about the effect of such a conclusion on the analysis of whether the asset managers should consolidate the funds.
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> 9. The SEC staff observer indicated that he anticipates the SEC staff would accept an application of Topic 606 for those arrangements. However, the observer noted that there may be a basis for following an ownership model. If an entity were to apply an ownership model, then the SEC staff would expect the full application of the ownership model, including an analysis of the consolidation model under Topic 810, the equity method of accounting under Topic 323, or other relevant guidance.
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> 10. The FASB staff does not recommend that the Board undertake standard-setting action as a result of this discussion. This is because the staff thinks Topic 606 is clear that performance based fees, such as carried interest arrangements, are within the scope of Topic 606. Several TRG members had the same view. In addition, each of the seven FASB Board members stated during the meeting that they believe that carried interests are within in the scope of Topic 606.

5. The following paragraphs assume the arrangement is within the scope of FASB ASC 606. If the entity determines that the arrangement is evaluated using the ownership model as described by the SEC staff observer above, the following evaluation does not apply.

6. For application of all of the steps of the revenue recognition model in FASB ASC 606 to performance fees, including industry-specific considerations in regard to constraining estimates of variable consideration, refer to Issue 10-5: "Incentive or Performance Fee Revenue, excluding incentive-based capital allocations (such as carried interest)". These steps and considerations apply equally to incentive-based capital allocation arrangements, irrespective of whether or not a cash distribution is made by the customer.

7. When evaluating the factors listed in paragraph 16 of Issue 10-5: "Incentive or Performance Fee Revenue, excluding incentive-based capital allocations (such as carried interest)", the asset manager should consider the nature of the incentive-based capital allocation specifically in regard to:
   a. The inputs of the calculation of the incentive-based capital allocations and the dependence of the ultimate incentive-based capital allocation on other factors, such as investment company performance waterfalls, hurdle rates (variable, index, fixed rate), or investment-by-investment calculations.
   b. The existence of clawback or other similar provisions.

8. In addition, FinREC believes that consideration should be given to the following factors in determining if variable consideration is constrained:
   a. The remaining life of the investment company;
   b. Whether the excess unrealized return remains susceptible to factors outside the entity's influence, including volatility in the fair value of the underlying portfolio of investments;
   c. The extent to which the current realized return and unrealized gains on investment collectively exceed the contractual hurdle rate.

9. In accordance with FASB ASC 606-10-32-11, an entity shall include in the transaction price some or all of 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.

10. As discussed in FASB ASC 606-10-32-12, determining the amount of variable consideration to include in the transaction price should consider both the likelihood and magnitude of a revenue reversal. An estimate of variable consideration is not constrained if the potential reversal of cumulative revenue recognized is not significant. FinREC believes that generally the incentive-based capital allocation may be considered significant as compared to the cumulative transaction price of the contract, which may include management and/or administrative fees, as this component of the transaction price has the potential to exceed other fees earned based on the nature and design of the fee structure.

11. Further, as explained in FASB/IASB TRG Agenda Ref 25, January 2015 Meeting – Summary of Issues Discussed and Next Steps, paragraph 49 states:

    TRG members generally agreed that the constraint on variable consideration should be applied at the contract level. Therefore the assessment of whether a significant reversal of revenue will occur in the future (the constraint) should consider the estimated transaction price of the contract rather than the amount allocated to a performance obligation.

12. Once included in the transaction price, an asset manager should determine whether a portion of the incentive-based capital allocation or the entire amount may be attributed to the distinct services already provided to the customer (for example, from the inception of the investment company through the date the variable consideration is unconstrained) in accordance with FASB ASC 606-10-32-39(b) and FASB ASC 606-10-32-40. Also, the asset manager should consider whether a portion of the unconstrained incentive-based capital allocation included in the transaction price should be allocated to any remaining performance period, based on facts and circumstances.

13. Consistent with guidance from TRG Agenda Ref. No. 55 and Example 25 of FASB ASC 606 cited above, FinREC believes that the following example demonstrates the application of the guidance on constraining estimates of variable consideration in FASB ASC Topic 606 to incentive-based capital allocations, such as a carried interest.

    Example – Applying the guidance on variable consideration to an incentive-based capital allocation arrangement

    A general partner ("GP"), an affiliate of an asset manager, is entitled to receive an incentive-based capital allocation equal to 20% of the appreciation of a closed-end three-year[2] limited partnership in excess of $8 million

[2] This example utilizes a fixed dollar contractual hurdle rather than an annual preferred return that often applies to capital contributed by limited partners and which are common in these arrangements. Consideration should be given to any preferred return for limited partners when assessing the asset manager's ability to meet contractual cumulative hurdles.

per annum, evaluated on a cumulative basis over the life of the investment company. The investment company has a calendar year-end. The GP holds a 0.01% general partnership interest and another entity under common control with the GP and the asset manager holds a 2% limited partner interest. Any distribution made prior to the end of the investment company's life is subject to a clawback provision if the cumulative investment company performance does not exceed the cumulative three-year hurdle of $24 million.

The GP enters into an investment management agreement with the affiliated asset manager to provide asset management and related services to the fund. For discussion about base management fees earned by the asset manager for the asset management services, see Issue 10-2: "Management Fee Revenue, excluding Performance Fee Revenue".

A three-year investment company life is assumed in this example for illustration purposes only; application of the key concepts in FASB ASC Topic 606 would similarly apply for longer term investment companies.

The evaluation performed herein is from the consolidated asset manager perspective, including the interests held by the general partner entity, limited partner entity and asset manager.

At the inception of the contract with the investment company, the consideration paid for asset management services in the form of incentive-based capital allocations is tied to variable factors, including, but not limited to, the ultimate realized return on the portfolio investment. As such, at contract inception, the asset manager determined that it cannot conclude that it is probable that a significant reversal of the calculated incentive-based capital allocations will not occur, so it did not include an estimate of the incentive-based capital allocation in the transaction price.

During the first year, the underlying investments in the investment company appreciated by $10,000,000. Accordingly, the asset manager's general partner account was allocated $1,000 (0.01% X $10,000,000) of the current year unrealized appreciation as well as $400,000 of the excess unrealized appreciation (20% of $2,000,000 excess unrealized appreciation ($10,000,000-$8,000,000)) while its limited partner account was allocated $200,000 (2% of $10,000,000), before the incentive-based capital allocation.

The following table illustrates the calculation of the allocation by the investment company in its standalone financial statements:

Year 1: Investment Company Reporting

	General Partner	**Affiliated Limited Partner**	**Third-Party Limited Partners**	**Total**
Net profit	$ 1,000	$ 200,000	$ 9,799,000	$ 10,000,000
Incentive-based capital allocation	400,000	(8,000)	(392,000)	-
Net profit after allocation	$ 401,000	$ 192,000	$ 9,407,000	$ 10,000,000

The asset manager evaluated the following additional factors to determine whether the incentive-based capital allocation should be constrained from inclusion in the transaction price in accordance with FASB ASC 606-10-32-11 to 32-12:

- The investment company is approximately 80% invested as of the end of Year 1 and the asset manager has identified the target investments to be made prior to the end of the investment period. The portfolio is comprised of non-marketable equity and debt investments in accordance with the investment objective stated in the limited partnership agreement. However, these investments may experience significant future volatility in value as they are primarily comprised of early-stage companies.
- The asset manager is still contemplating the ultimate exit plan for each of the portfolio investments, such as IPO or direct sale.
- The expected remaining life of the investment company is considered long-enough for the investment company to experience declines in the annual appreciation below the contractual hurdle (and ultimately in the cumulative hurdle as well).
- The excess unrealized return over the contractual hurdle for the year (returns of $10,000,000 over the contractual hurdle of $8,000,000) remains susceptible to factors outside the entity's influence,

particularly volatility in the fair value of the underlying portfolio investments. Additionally, the appreciation to-date of $10,000,000 does not exceed the cumulative hurdle required at the end of Year 3 of $24,000,000.

Based on these factors, the asset manager determined that it cannot conclude that it is probable that a significant reversal of the calculated incentive-based capital allocations will not occur, so it did not include an estimate of the incentive-based capital allocation in the transaction price as of December 31st of Year 1.

During the second year, the underlying assets in the investment company appreciated by $7,000,000. A portion of the first year's incentive-based capital allocation is then reallocated back to the limited partners because the inception-to-date market appreciation of $17,000,000 ($10,000,000+7,000,000) only exceeds the cumulative contractual hurdle of $16,000,000[3] by $1,000,000. As a result, the cumulative incentive-based capital allocation must be reduced by $200,000[4]. The allocation by the investment company in its standalone financial statements would be as follows:

Year 2 (non-cumulative): Investment Company Reporting

	General Partner	Affiliated Limited Partner	Third-Party Limited Partners	Total
Net profit	$ 700	$ 140,000	$ 6,859,300	$ 7,000,000
Incentive-based capital allocation	(200,000)	4,000	196,000	-
Net profit after allocation	($ 199,300)	$ 144,000	$ 7,055,300	$ 7,000,000

Further, the asset manager evaluated the following factors to determine whether the incentive-based capital allocation should be constrained:

- The investment company's portfolio is fully invested and significant changes to the population of investments are unlikely. The asset manager is required to distribute all income (dividends and interest) earned from the underlying portfolio. However, the underlying investee companies are still early-stage companies subject to significant volatility in value.
- The investment company continues to be subject to significant market volatility over the remaining year of the investment company's life that could result in a decline in the annual return below the contractual hurdle.
- No portfolio investments have been acquired, sold or otherwise transferred to a third-party (e.g., through an IPO), and there are no current negotiations being undertaken for the sale of the investments.
- The inception-to-date excess unrealized return over the inception-to-date contractual hurdle remains susceptible to factors outside the entity's influence, particularly volatility in the fair value of the underlying portfolio investments.
- The cumulative returns to-date of $17,000,000 do not exceed the cumulative hurdle required at the end of Year 3 of $24,000,000.
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Based on these factors, the asset manager determined that it cannot conclude that it is probable that a significant reversal of the cumulative incentive-based capital allocation of $200,000 ($400,000 allocated in Year 1 less the reversal of $200,000 in Year 2) will not occur, so it did not include an estimate of the incentive-based capital allocation in the transaction price as of December 31st of Year 2.

During the six months ended June 30th of the third and final year of the investment company's life (that is, prior to the calendar year end), the investment company recognized net gains of $11,000,000. The investment company liquidated approximately 90% of its portfolio resulting in cumulative realized gains of $28,000,000, comprised of $11,000,000 of current period gains and a reclassification of previously recorded unrealized gains of $17,000,000. This reclassification had no impact on total net increase in net assets of the investment company (the investment company equivalent of net income) through June 30th of Year 3. There is no anticipated realized gain or loss on the remaining 10% of the portfolio as of June 30th; this assertion is supported by the soon-to-be executed sale of these investments at their acquisition cost (current negotiation for their sale is well-underway). The inception-to-date gains of $28,000,000 exceeds the cumulative contractual hurdle as of June 30th of $20,000,000[5], resulting

[3] Contractual hurdle at the end of Year 2 is calculated as $8,000,000 x 2 years.
[4] $400,000 Year 1 allocation minus $200,000, the Year 2 allocation. The Year 2 allocation is calculated as 20 percent of $1,000,000 ($17,000,000 - 16,000,000, the cumulative hurdle amount as of Year 2).
[5] Hurdle rate calculated as $8,000,000 annual hurdle multiplied by 2 ½ years.

in a cumulative incentive-based capital allocation of $1,600,000[6]. In the current year, the asset manager's general partner account would be allocated $1,100 (0.01% X $11,000,000) of the current year realized appreciation as well as the additional $1,400,000[7] capital allocation needed to arrive at the total incentive-to-date allocation of $1,600,000. Its limited partner account would receive an allocation of $220,000 (2% of $11,000,000), before the incentive-based capital allocation.

The allocation as of June 30th of Year 3 by the investment company in its standalone financial statements is as follows:

Year 3 – June 30th (non-cumulative): Investment Company Reporting

	General Partner	Limited Partner	Third-party Limited Partners	Total
Net profit	$ 1,100	$ 220,000	$ 10,778,900	$ 11,000,000
Incentive-based capital allocation	1,400,000[8]	(28,000)	(1,372,000)	-
Net profit after allocation	$ 1,401,100	$ 192,000	$ 9,406,900	$ 11,000,000

For the purposes of revenue recognition, the asset manager evaluated the following additional factors to determine whether the incentive-based capital allocation should be constrained:

- The investment company has liquidated 90% of its portfolio and is in the process of selling the remaining investments. The proceeds from the sales are held in cash and cash equivalents subject to final distribution to the limited partners.
- The sale of the remaining portfolio is nearly finalized and the terms of the draft contract indicate no anticipated gains or losses.
- Given the sale of substantially all of the investment company's underlying investments and significant negotiations for the remaining investments, the investment company is no longer subject to significant market volatility.
- The excess appreciation earned to date is significantly higher than the contractual hurdle.

Given the change in the composition of substantially all of the underlying investment portfolio to cash and cash equivalents, which is not expected to experience significant market fluctuations over the remaining six months of the investment company's life, the asset manager determined that it is probable that a significant reversal of the inception-to-date capital allocation will not occur for a portion of the incentive-based capital allocation. Assuming no further appreciation on the remaining 10% of the portfolio yet to be sold, the asset manager determined the amount of incentive-based capital allocation which can be included in the transaction price to be $800,000[9] as of June 30th. The amount of variable consideration was determined based on the expected value method.

Upon inclusion of the $800,000 in the transaction price, a portion of the $800,000 or the entire amount may be allocated to the distinct services provided from the investment company's inception through June 30th of Year 3 in accordance with FASB ASC 606-10-32-39(b) and FASB ASC 606-10-32-40.

In this particular situation, the asset manager determines that the full $800,000 is allocated to the asset management services provided to the investment company from the investment company's inception through June 30th of Year 3. The fee relates to the entity's efforts to transfer the services for the period from inception through June 30th of Year 3, which are distinct from the services to be provided for future quarters and therefore would be consistent with the allocation objective in FASB ASC 606-10-32-28. Further, the returns on the investments have been realized and substantially all of the services associated with the sale of the remaining portfolio investments have been completed.

The following table illustrates the difference between attribution of the incentive-based allocation performed by the investment company and the asset manager's inclusion of such variable consideration in the transaction price and, ultimately, in its recorded revenue:

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[6] 20 percent of $8,000,000 ($28,000,000 – $20,000,000).

[7] Cumulative incentive-based capital allocation of $1,600,000 less inception-to-date net allocation of $200,000.

[8] 20 percent of $7,000,000 (Year 3 year-to-date gains of $11,000,000 less pro-rated annual hurdle of $4,000,000).

[9] 20 percent of $4,000,000 ($28,000,000-24,000,000). In determining this amount, the asset manager compared the cumulative amount of realized earnings of $28,000,000 (through June 30th of Year 3) to the cumulative three-year hurdle of $24,000,000.

		Consolidated Asset Manager	
	Investment Company Allocation	**Included in Transaction Price**	**Recognized as Revenue**
Year 1	$ 400,000	$ -	$ -
Year 2	(200,000)	-	-
Year 3 – June 30th	1,400,000	800,000	800,000
TOTAL	$ 1,600,000	$ 800,000	$ 800,000

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.