Working Draft:

Asset Management Revenue Recognition Implementation Issue

Issue # 10-5: Incentive or Performance Fee Revenue, excluding incentive-based capital allocations (such as carried interest).

Expected Overall Level of Impact to Industry Accounting:

Minimal

Wording to be Included in the Revenue Recognition Guide:

Background

1. Incentive or performance fees (collectively, "performance fee") represent variable consideration paid by the customer for asset management services when the performance of the fund or separate account exceeds a specified benchmark or contractual hurdle over a contractual performance period or the life of the fund. These fees may be calculated as a percentage of assets under management ("AUM"), the market appreciation of the fund or separate account, or other criteria. For a discussion on incentive-based capital allocations, refer to Issue 10-5A "Incentive-Based Capital Allocations".

2. Example 25 in FASB ASC 606-10-55-221 through 606-10-55-225 illustrates application of the guidance on variable consideration to performance fees. As noted in this example, performance fees paid as consideration for asset management services may not be included in the transaction price because "the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price." (FASB ASC 606-10-55-224)

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

3. Industry considerations relevant to the determination of the customer and applicable to this step are discussed in detail within Issue 10-1 "Determining the Customer in an Asset Management Arrangement".

4. Additionally, considerations relevant in identifying the contract with the customer are discussed in detail within the Issue 10-8 "Identifying the Contract". Notably, services provided to the customer may be described in either a governing document, such as the fund prospectus, or in a separate investment management agreement.

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

5. The asset manager should identify the performance obligations within the contract at inception of the contract. 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, [or] (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."

6. The asset manager should consider the specific terms of the contract and the unique facts and circumstances of the arrangement when determining the performance obligation to which the customer's payment of performance fees relates, pursuant to the guidance in FASB ASC 606-10-25-14 and related paragraphs.

7. FASB ASC 606-10-25-19 requires a promised service to meet the following criteria in order to be distinct, and hence to represent a performance obligation:
    a. The customer benefits from the service either on its own or together with other resources that are readily available to the customer (that is, the service is capable of being distinct), and
    b. The asset manager's promise to transfer its service must be separately identifiable from other promises in the contract (that is, the promise to transfer the service is distinct within the context of the contract).

8. Consistent with Example 25, in FASB ASC 606-10-55-221 through 55-225, and as described in Issue 10-2 "Management Fee Revenue (Service Fee Revenue), excluding Performance Fees", the promise to provide asset management services is considered a single performance obligation because the asset manager transfers a series of distinct services (that is, daily asset management services) that are substantially the same and have the same pattern of transfer to the customer.

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

9. In accordance with FASB ASC 606-10-32-1, the transaction price that the asset manager expects to receive is comprised of variable consideration in the forms of base management and performance fees that are not constrained in accordance with FASB ASC 606-10-32-11 through 32-13.

10. Considerations relevant in evaluating management fee revenue are discussed in detail within Issue 10-2 "Management Fee Revenue (Service Fee Revenue), excluding Performance Fees".

Determining the transaction price - variable consideration (FASB ASC 606-10-32-5 to 606-10-32-9)

11. In accordance with FASB ASC 606-10-32-5, consideration paid for asset management services in the form of performance fees is considered variable because it is subject to fluctuation with respect to amount (for example, in asset value, market performance) and/or is contingent on a future event during the contractual period (for example, meeting a specified compound hurdle rate).

12. FASB ASC 606-10-32-8 requires that the amount of variable consideration is estimated using one of the following two methods, depending on which method the asset manager 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.

13. In accordance with FASB ASC 606-10-32-9, the asset manager should consider all the information (historical, current, and forecast) that is reasonably available to the entity, including its historical experience with similar arrangements in similar jurisdictions to determine the estimate of variable consideration. Consideration should be given to the accuracy of previously forecasted results and actual fund performance to help determine if there is a range of possible consideration amounts that could be used to derive the expected value (that is, in a probability-weighted estimate) or most likely amount to which the entity will be entitled.

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

14. As discussed in FASB ASC 606-10-32-11, an asset manager 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. Consistent with the factors listed in FASB ASC 606-10-32-12, while an asset manager may have historical experience with similarly structured fee arrangements, this history may have low predictive value of the future market performance. Further, the amount of performance fees is typically subject to certain contingencies outside of the control of the asset manager, such as market volatility, and may have a broad range of possible consideration amounts.

15. Therefore, in accordance with FASB ASC 606-10-32-11, variable consideration in the form of performance fees will be excluded from the transaction price until it becomes probable that there will not be a significant reversal of cumulative revenue recognized.

16. An asset manager may determine that all or a portion of its performance fees is not constrained from being included in the transaction price based on an assessment of the factors in FASB ASC 606-10-32-12 conducted either at inception of the contract or upon subsequent re-evaluation, and that such amount should be recognized prior to the end of the performance period if the relevant facts and circumstances indicate that it is probable that significant reversal will not occur. In making this assessment, the entity may consider such factors as:
    a. The extent to which the underlying investment portfolio is subject to future changes, such as market volatility and investment and reinvestment, which could impact the calculation of the performance fees.
    b. The extent to which there is a return on investment in excess of the contractual hurdle rate.
    c. The time remaining in the performance period.

    See paragraphs 28-31 below for an example of this evaluation.

Allocating the transaction price to performance obligations (FASB ASC 606-10-32-28 through 606-10-32-41)

17. As discussed in FASB ASC 606-10-32-39, variable consideration may be attributed to the entire contract or to a specific part of the contract. When there is more than one performance obligation in a contract or there are distinct goods or services promised as part of a single performance obligation, variable consideration may be attributed to one or more, but not all, of those performance obligations or distinct goods or services, respectively.

18. 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 goods or services that forms part of a single performance obligation, 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.

19. 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.

20. Consistent with FASB ASC 606-10-55-225, at the end of the reporting period the entity should allocate an amount of unconstrained variable consideration to the distinct services provided during the reporting period in accordance with FASB ASC 606-10-32-39(b) and FASB ASC 606-10-32-40.

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

21. For each performance obligation, an entity must 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. A performance obligation must be satisfied over time in order to meet the criterion in FASB ASC 606-10-25-15(a) to be a series of distinct goods or services.

22. Consistent with the guidance illustrated in Example 25 in FASB ASC 606-10-55-222, the performance obligation to provide asset management services represents a series of distinct services that are substantially the same and have the same pattern of transfer to the customer. With respect to the latter point, 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 criterion in FASB ASC 606-10-25-27(a) to recognize revenue over time is met because the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

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

23. If the performance obligation is satisfied over time, the entity would next determine how to measure progress towards complete satisfaction of the performance obligation. An entity must determine if an output method or an input method, as described in FASB ASC 606-10-55-16 through 55-21, is more appropriate for measuring progress. The selected method must be applied consistently to similar performance obligations and in similar circumstances.

24. FinREC believes that a time-based measure of progress, as described in FASB 606-10-55-222, is the appropriate approach for recognizing revenue over time because the services are substantially the same each day and have the same pattern of transfer.

25. Entities should consider guidance in FASB ASC 606-10-25-36 through 606-10-25-37, and conclude whether their selected methodology is a reasonable measure of progress based on reliable inputs. An entity may only recognize revenue if it can reasonably measure progress toward complete satisfaction of the performance obligation.

26. The following examples are meant to be illustrative, and the actual application of the guidance in FASB ASC 606-10-32-5 through 32-14 for estimating variable consideration to be included in the transaction price should be based on the facts and circumstances of an entity's specific situation.

Example 1 – Performance fees:

An asset manager enters into an investment management agreement ("IMA") with a hedge fund for the provision of investment advisory services. The asset manager is entitled to a monthly management fee equal to 0.50 percent of the monthly average assets under management. Additionally, the asset manager is entitled to a performance fee equal to 20 percent of the gross annual return of the fund in excess of the 12 percent contractual hurdle rate. The performance fee, assuming the hurdle rate is met, is paid at the end of the calendar year. There is no provision in the IMA that requires the asset manager to return amounts paid in previous calendar years if in subsequent years the hurdle rate is not met (that is, there is no "clawback" provision).

The following evaluations represent considerations for two years in the life cycle of the hedge fund and are for illustrative purposes only. The same evaluation would be performed in other performance periods.
As of September 30th of the fifth calendar year, the fund had gross year-to-date appreciation of 20 percent. There are no restrictions on the continued investment or reinvestment of the fund's portfolio holdings. Since inception, similar funds in the related investment objective have experienced quarterly market volatility ranging from depreciation of 10 percent to a return of 25 percent.

The asset manager determined that it is not probable that a significant reversal of the calculated 1.6 percent performance fee (20 percent of the 8 percent gross annual appreciation in excess of the contractual hurdle rate) will not occur based on the following factors:

- The fund has the ability to invest or reinvest its proceeds into additional portfolio holdings.
- The fund is subject to significant market volatility in the fourth calendar quarter which could result in a decline in the gross annual return below the contractual hurdle.
- The current gross annual return earned to date is not significantly higher than the contractual hurdle.
-

Based on these factors, the asset manager did not include an estimate of the performance fee in the transaction price as of September 30th of the fifth calendar year.

As of September 30th of the ninth calendar year, the fund had gross year-to-date appreciation of 50 percent. During the year, the investment portfolio was sold and the proceeds were invested in a money market fund to preserve the year-to-date gains.

The asset manager determined that it is probable that a significant reversal of the calculated 7.6 percent performance fee (20 percent of the 38 percent gross annual appreciation in excess of the contractual hurdle rate) will not occur:

- The fund composition changed from a portfolio of investments to a single investment in a money market fund with a stable net asset value of $1.
- While the fund is subject to market volatility in the fourth calendar quarter, which could result in a decline in the gross annual return, any decline would not be expected to be significant given the type of underlying funds (for example, treasuries) and the return through September 30 significantly exceeds the contractual hurdle.
- The current gross annual return earned to date is significantly higher than the contractual hurdle.

Given the change in the composition of the underlying investment portfolio to a money market fund with a stable net asset value, the full performance fee of 7.6 percent is included in the transaction price as of September 30th of the ninth calendar year. However, the asset manager should evaluate whether the unconstrained performance fee is allocated to the distinct services provided prior to September 30th of the ninth calendar year in accordance with FASB ASC 606-10-32-39(b) and FASB ASC 606-10-32-40 or if a portion should be deferred and recognized over the remaining performance period.

If the investment portfolio was not moved to an investment in a money market fund with a stable net asset value and therefore still subject to additional market fluctuations, the asset manager should consider whether a portion of the 7.6 percent performance fee would still be subject to the constraint guidance.

Example 2 - fulcrum fees[1]:

Certain performance fees may be structured with a floor and a performance-based component ("fulcrum" fees) or as a weighted average of performance over a period of several years. In such cases, the uncertainty may only apply to a portion of the performance fee, which could result in partial recognition of the performance fee. Careful attention should be paid to the specific facts and circumstances of each performance fee when determining any constraint on the estimate of performance-based consideration that may be included in the transaction price.
As an example, the prospectus for a fund may contain the following fee provisions:

> The management fee will be 0.60 percent of average quarterly AUM. If fund performance outperforms its benchmark index on the annual basis by:
>
> - 1 percent but less than 2 percent the management fee will be increased to 0.65 percent of average AUM;
> - 2 percent but less than 4 percent, the management fee will be increased to 0.70 percent of average AUM; and
> - 4 percent or greater, the management fee will be increased to 0.75 percent of average AUM.
>
> If the fund underperforms its benchmark index by:
>
> - 1 percent but less than 2 percent the management fee will be decreased to 0.55 percent of average AUM;
> - 2 percent but less than 4 percent, the management fee will be decreased to 0.50 percent of average AUM; and
> - 4 percent or greater, the management fee will be decreased to 0.45 percent of average AUM.

In such a case, the minimum (or fixed) portion of the fulcrum fees (in the above example the minimum is the 0.45 percent fee) for the given quarter becomes fixed as compared to its benchmark index. Therefore, the minimum fee would be evaluated consistent with other base management fees at the end of each quarterly reporting period including consideration of the constraint guidance, as described in Issue 10-2 "Management Fee Revenue (Service Fee Revenue), excluding Performance Fees".

Depending on the facts and circumstances of the arrangement, the asset manager may exclude the fulcrum fee earned above the minimum fee of 0.45 percent from the transaction price because it is not probable that a significant reversal of the fee will not occur prior to the end of the performance period, and, therefore, the amount is constrained. If this is the case, then the performance-based component of the fulcrum fee should be excluded from the transaction price until it becomes probable that there will not be a significant reversal of cumulative revenue recognized based on the factors in FASB ASC 606-10-32-12 as well as specific considerations for the asset management industry described in paragraph 16.

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.

[1] Fulcrum fees are performance-based fees in which advisers to mutual funds are compensated depending on how well their managed fund performed relative to a particular benchmark. The fulcrum fee is made up of two components—the base fee, which represents the midpoint of the entire fulcrum fee, and the incentive adjustment. Generally, the adviser is paid the base fee if the fund's performance matches the performance of the benchmark. If the fund outperforms its benchmark, the adviser receives an incentive payment in addition to the base fee. Conversely, if the fund underperforms its benchmark, the adviser is penalized and the base fee is reduced by a negative incentive adjustment.