

## Financial Reporting Center – Revenue Recognition

# Working Draft: Broker-Dealer Revenue Recognition Implementation Issue



### Issue #3-1: Commission Income

**Expected Overall Level of Impact to Industry Accounting:**  
Minimal

### Wording to be Included in the Revenue Recognition Guide:

*Identify the contract(s) with a customer*

1. Acting as an agent, a broker-dealer may buy and sell securities on behalf of its customers. In return for such services, the broker-dealer charges a commission. Each time a customer enters into a buy or sell transaction, a commission is charged by the broker-dealer for its selling and administrative efforts.
2. Typically, a customer signs one contract with a broker-dealer that governs the terms and conditions for trade execution, clearing, custody and potentially other services (i.e., the promised goods and services included in a single contract).
3. If the contract includes a separate fee for custody services or a guaranteed minimum number of trades, FinREC believes the contract will typically meet all of the criteria in FASB Accounting Standards Codification (ASC) 606-10-25-1 through 25-3 to be accounted for as a contract under the standard when the customer deposits money or transfers securities into an account, executes a trade, or the contractual term of the custody services have begun. Prior to these actions by the customer, a contract does not exist in accordance with ASC 606-10-25-4 because the contract is wholly unperformed and either party could terminate the arrangement.
4. If the contract does not include a separate fee for custody services or a guaranteed minimum number of trades, FinREC believes the contract will not meet the criteria in FASB ASC 606-10-25-1 until a trade order is submitted by the customer (even if the customer deposits money or transfers securities into an account) because the customer has no obligation to pay the broker-dealer any consideration for its services. That is, the contract has no commercial substance in this case until a trade order is placed.
5. A typical brokerage contract generally can be terminated at will by either the customer or broker-dealer. FASB ASC 606-10-25-3 explains that when a contract has no fixed duration and can be terminated or modified by either party at any time, an entity should apply the

guidance in FASB ASC 606 to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations, unless a customer has a material right that extends beyond the contract term. For broker-dealers, this duration may be a one-day period (or shorter) in cases where the contract is terminable at will. Additional consideration and analysis may be required for brokerage contracts with a specified term (such as, one year).

*Identify the performance obligations in the contract*

6. In applying FASB ASC 606, a broker-dealer should evaluate all of the services promised in the brokerage contract, including those implied by a broker-dealer's customary business practice, to identify the separate performance obligations. Some common services in a brokerage contract include trade execution, clearing services, custody services and investment research services (investment research services are addressed in Implementation Issue Paper 3-6 on soft-dollar arrangements). A broker-dealer should carefully consider whether each service is capable of being distinct and is distinct within the context of the contract in accordance with paragraphs 19–21 of FASB ASC 606-10-25.
7. Judgment is required when determining whether clearing services are distinct within the context of the contract (that is, separately identifiable). Generally, FinREC believes trade execution and clearing services are not separately identifiable in the context of a typical contract with a retail customer because they are both inputs to the combined output of security trading. Therefore, they are bundled into a single distinct service (hereafter, collectively referred to as trade execution).
8. FinREC believes that trade execution and custody services are distinct. Trade execution and custody services provide a benefit to the customer either individually or together with other resources that are readily available to the customer (i.e., a customer can benefit from custody services or trade execution services on their own). The two services are also separately identifiable in accordance with FASB ASC 606-10-25-21. Although the custody affects the trade execution service, the trade execution service does not affect the custody service, so the services do not affect each other and are not highly interdependent or interrelated. For example, a customer could transfer securities to a different broker-dealer without executing a trade with them and receive the benefit of custody services.
9. While the custody service performance obligation is required to be performed as part of the contract (see discussion in paragraphs 3 and 4 above on the existence of a contract), trade execution is performed if a customer requests the broker-dealer to initiate a trade. The option for trade execution services represents an option to purchase services in addition to the custody service instead of variable consideration (see TRG Agenda Ref. 49<sup>1</sup>) because the customer has a present contractual right to choose the amount of additional distinct services that are purchased (i.e., a separate purchasing decision). However, if a contract stipulates a guaranteed minimum number of trades, those trades are considered performance obligations.
10. Even if a contract does not exist until the first trade is executed, any trades beyond the first are considered optional purchases.
11. An option gives rise to a separate performance obligation in the contract only if it provides a material right to the customer in accordance with FASB ASC 606-10-55-42. FASB ASC 606-

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<sup>1</sup> Paragraph 9 of TRG FASB/IASB TRG Agenda Ref 49, November 2015 Meeting – Summary of Issues Discussed and Next Steps, states:

“TRG members agreed that an important first step to distinguishing between optional goods or services and variable consideration for promised goods or services is to identify the nature of the entity's promise to the customer as well as the enforceable rights and obligations of the parties. With an option for additional goods or services, the customer has a present right to choose to purchase additional distinct goods or services (or change the goods and services to be delivered). Prior to the customer's exercise of that right, the vendor is not presently obligated to provide those goods or services and the customer is not obligated to pay for those goods or services. In the case of variable consideration for a promised good or service, the entity and the customer previously entered into a contract that obligates the entity to transfer the promised good or service and the customer to pay for that promised good or service. The future events that result in additional consideration occur after (or as) control of the goods or services have (or are) transferred. When a contract includes variable consideration based on a customer's actions, those actions do not obligate the entity to provide additional distinct goods or services (or change the goods or services to be transferred), but rather, resolve the uncertainty associated with the amount of variable consideration that the customer is obligated to pay the entity.”

10-55-43 states that if the price of the additional goods and services to be provided reflects the standalone selling price for that good or service, then that option does not provide a material right to the customer. FASB/IASB TRG Agenda Ref 11, October 2014 Meeting – Summary of Issues Discussed and Next Steps, paragraph 7 states:

“Most TRG members agreed that the evaluation of whether an option provides a material right should consider relevant transactions with the customer (that is, current, past, and future transactions) and should consider both quantitative and qualitative factors, including whether the right accumulates (for example, loyalty points).”

A broker-dealer should evaluate the pricing of its trade execution services, among other qualitative factors, to determine whether the option gives rise to a material right.

12. In accordance with FASB ASC 606-10-55-43, options to purchase trade execution services priced at the standalone selling price for that class of customer (for example, retail, institutional) are not considered separate performance obligations and are accounted for only when the customer exercises the option to purchase the trade execution services. Trade execution services priced at a discount to the standalone selling price, including trade execution service pricing that includes volume discounts, may represent a material right and be accounted for as a separate performance obligation.
13. Broker-dealers should also consider whether the typical retail customer has a material right for custody services to be provided beyond the contractual term of the arrangement (e.g., one day; see further discussion in paragraph 5 above). FASB TRG Agenda Ref 54, Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right, paragraph 12 states:

“...The guidance in paragraphs 606-10-55-42 through 55-43 is intended to make clear that customer options that would exist independently of an existing contract with a customer do not constitute performance obligations in that existing contract.”

Custody services that could be provided beyond the contractual term of the contract for no consideration would exist independently of an existing contract with a customer when a broker-dealer provides custody services to customers who do not have an existing contract with the broker-dealer for no consideration. In these cases, FinREC believes there is no material right for future custody services. A material right may exist if the customer only receives the custody services for no consideration because of previously executed trades with the broker-dealer.

*Determine the transaction price*

14. Typically, the transaction price for the brokerage contract that covers both trade execution and custody services is based solely on the commission rate quoted by the broker-dealer for trade execution. However, a separate fee may be charged for custody services in contracts that require the processing and handling of physical certificates or legal documents or accounts that have limited or no activity. Any separate fee for custody services is included in the transaction price at contract inception if it is not constrained. In addition, any guaranteed minimum on trade commissions is also included in the transaction price at contract inception.
15. Since the trade execution service is not accounted for until the option is exercised (assuming it is not a material right and there is no guaranteed minimum number of trades) in accordance with FASB ASC 606-10-55-43, the consideration for the optional services is also not included in the transaction price until the option is exercised. An entity should not estimate the options that might be exercised in determining the transaction price.

*Allocate the transaction price to the performance obligations in the contract*

16. At contract inception, there is only one performance obligation (i.e., custody services) if there is a separate fee charged for custody services assuming the option for trade execution services is not a material right and there is no guaranteed minimum number of trades. In this case, the separate fee for the custody services is allocated only to the custody services. If there is no separate fee charged and no guaranteed minimum number of trades, there is no contract until the first trade is executed.

17. The exercise of each option for trade execution services is accounted for either as a change in the transaction price (in accordance with FASB ASC 606-10-32-42 to 606-10-32-45) or a modification (in accordance with FASB ASC 606-10-25-10 to 606-10-25-13) of the original contract (see paragraphs 11 -12 of FASB/IASB TRG Agenda Ref 34, March 2015 Meeting – Summary of Issues Discussed and Next Steps). Most TRG members and the FASB staff thought both views were supportable by the language in the revenue standard (as cited above) because the exercise of an option could result in additional consideration being allocated to the option (i.e., a change in the transaction price) or a change in the scope and/or price of a contract (i.e., a contract modification). Paragraph 12 of FASB/IASB TRG Agenda Ref 34 states: “TRG members observed that in most, but not all, cases the financial reporting outcome of applying [either view] would be similar. Only in cases in which the optional goods or services are determined to be not distinct from the original promised goods or services, would the results appear to differ. The staff thinks that an entity typically would conclude that an optional good or service is distinct...TRG members agreed with the staff view that the method used should be applied consistently by an entity to similar types of material rights with similar facts and circumstances.”
18. If a broker-dealer accounts for the exercise of the option as a contract modification in accordance with paragraph 11 of the FASB/IASB TRG Agenda Ref. 34, and determines the trade execution services are priced at their standalone selling price, it accounts for the trade execution service as a separate contract and does not allocate any consideration from the trade commission to the custody services in accordance with FASB ASC 606-10-25-12. If the broker-dealer determines that the trade execution services are not priced at their standalone selling price, the modification of the contract is treated as the termination of the existing contract and the creation of a new contract in accordance with FASB ASC 606-10-25-13(a). The amount of consideration to be allocated to the remaining custody services and trades is the sum of the unrecognized custody fee (if any), the unrecognized guaranteed minimum trade commission (if any), and the trade commissions from the additional trades. A broker-dealer then allocates the transaction price to the trade execution services and custody service based on their relative standalone selling prices. However, assuming the contract is terminable at will, both performance obligations are satisfied by the end of the day, so no allocation is required in these circumstances unless the broker-dealer separately presents trade execution services and custody services in its financial statements.
19. If a broker-dealer accounts for the exercise of the option as a change in the transaction price<sup>2</sup> in accordance with paragraph 11 of the FASB/IASB TRG Agenda Ref. 34, the trade commission from any exercised trade execution option is added to the total transaction price and allocated to the custody services and trade execution services based on their respective standalone selling prices in accordance with FASB ASC 606-10-32-29. However, assuming the contract is terminable at will, both performance obligations are satisfied at the same time, so no allocation is required in these circumstances unless the broker-dealer separately presents revenue from trade execution services and custody services in its financial statements.
20. If volume discounts are provided in the contract and the broker-dealer identifies the option as a material right, it allocates a portion of the transaction price from each trade to the material right based on their relative standalone selling prices in accordance with FASB ASC 606-10-32-29. FASB ASC 606-10-55-44 provides guidance for estimating the standalone selling price of an option. The amount allocated to the material right is recognized as revenue when the option for the additional trades priced at a discount is exercised or the option expires.

*Recognize revenue when (or as) the entity satisfies a performance obligation*

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<sup>2</sup> Paragraph 11 of FASB/IASB TRG Agenda Ref 34, March 2015 Meeting – Summary of Issues Discussed and Next Steps, states:

On Issue 1, most TRG members agreed with the staff view that View C (the exercise of a material right should be accounted for as variable consideration) is not supported by the guidance in the new revenue standard. TRG members agreed with the staff view that the guidance in the standard could be interpreted to support the following views.

- a) View A: At the time a customer exercises a material right, an entity should update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise. The additional consideration should be allocated to the performance obligation underlying the material right and should be recognized when or as the performance obligation underlying the material right is satisfied.
- b) View B: The exercise of a material right should be accounted for as a contract modification. That is, the additional consideration received and/or the additional goods or services provided when a customer exercises a material right represent a change in the scope and/or price of a contract. An entity should apply the modification guidance in paragraphs 606-10-25-10 through 25-13.

21. In accordance with FASB ASC 606-10-25-24, a broker-dealer should then identify whether any performance obligations are satisfied over time or at a point in time. FinREC believes that custody services meet the criteria in FASB ASC 606-10-25-27 as the customer simultaneously receives and consumes the benefits provided by the broker-dealer as the broker-dealer performs the services, and are considered satisfied over time. The broker-dealer must then determine a measure of progress (for example, time elapsed) that best predicts its performance in satisfying the custody services and recognize the portion of the transaction price allocated to the custody services as revenue as the services are provided (for example, over the one day period, or a longer period of time if the custody period is specified and not terminable).
22. A broker-dealer should also evaluate whether the trade execution performance obligation, after the additional purchasing decision is made, meets any of the criteria in paragraph 27 of FASB ASC 606-10-25 to be satisfied over time. FinREC believes it is unlikely that trade execution will meet the criteria in paragraph 27 (b) or (c) of FASB ASC 606-10-25. In addition, because a broker-dealer is performing the service of providing the customer with the ability to acquire or dispose of rights to obtain the economic benefits of a financial instrument (for example, stock, bonds, options), the customer does not simultaneously receive and consume the benefits provided by the broker-dealer's service as it performs (that is, the criterion in paragraph 27(a) of FASB ASC 606-10-25 is not met). In other words, the customer only consumes the benefits of the broker-dealer's service when the customer acquires or disposes of the rights to obtain the economic benefits of the financial instrument, not as the broker-dealer performs the underlying service to acquire or dispose of those rights. Therefore, FinREC believes the trade execution performance obligation is satisfied at a point in time.
23. For performance obligations that are satisfied at a point in time, a broker-dealer needs to determine the point in time at which the customer obtains control (that is, obtains the benefits from that service) and should consider the indicators of transfer of control in FASB ASC 606-10-25-30. For a discussion of whether the trade execution performance obligation is satisfied on the trade date or the settlement date, see Implementation Issue Paper 3-1A.

Comments should be received by January 2, 2017, and sent by electronic mail to Irina Portnoy at [iportnoy@aicpa.org](mailto:iportnoy@aicpa.org), or you can send them by mail to Irina Portnoy, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.