

Financial Reporting Center – Revenue Recognition

Working Draft: Broker-Dealer Revenue Recognition Implementation Issue



Issue #3-3A: Costs Associated with Investment Banking Advisory Services

Expected Overall Level of Impact to Industry Accounting:
Moderate

Wording to be Included in the Revenue Recognition Guide:

1. A customer may engage a broker-dealer to provide advisory services for various purposes. A common example is to provide financial advice and assistance in connection with the sale of a company. The advisory service may include activities such as developing a list of buyers, preparing marketing materials, soliciting interest from prospective buyers, preparing for and responding to due diligence investigations, assistance with financial forecasts and analyses, negotiating the transaction and rendering a fairness opinion letter. As compensation for the advisory service, a broker-dealer will receive a fee upon closing of the transaction (i.e., success-based fee) and/or upon achieving certain milestones (e.g., upon an announcement of the transaction or delivery of a fairness opinion). In addition, the broker-dealer may receive a retainer fee. See related Issue 3-5, Investment Banking Advisory Fees, for further discussion of revenue recognition of advisory fees.

Initial Recognition

Incremental costs of obtaining a contract

2. To obtain an advisory contract with a customer, a broker-dealer may incur costs such as advertising, selling and marketing costs, bid and proposal costs, sales commissions, and legal fees. FASB ASC 340-40-25-1 requires an entity to recognize an asset for the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. Generally, legal fees to draft the contract to provide services to the customer, advertising, selling and marketing costs and bid and proposal costs are not incremental, as the broker-dealer would have incurred those costs even if it did not obtain the advisory contract. Sale commissions would be incremental costs as these costs would not have been incurred if the contract had not been obtained. In accordance with FASB ASC 340-10-25-1, if the incremental costs are recoverable from the customer, the broker-dealer should defer the costs and recognize an asset. An entity can expect to recover contract acquisition costs through direct recovery (i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). FinREC

believes the recoverability criterion for recognizing a deferred asset typically will not be met when the acquisition costs are expected to be indirectly recovered solely through fees that are dependent upon events and circumstances that are outside the control of the broker-dealer (e.g., certain success-based fees). However, an entity should consider if the arrangement includes non-refundable fees that it expects to collect (e.g., retainer fee, termination fee) that may demonstrate the entity can recover these costs, or a portion of the costs, and therefore meet the recoverability criterion for capitalization up to the recoverable amount.

3. FASB ASC 340-10-25-4 provides a practical expedient whereby the broker-dealer may recognize the incremental costs of obtaining a contract as an expense when incurred, provided the amortization period of the asset that it otherwise would have recognized the expense over is one year or less. Often, the service for many advisory contracts will be transferred to the customer within one year and therefore an entity may elect to expense the costs to obtain such contracts as incurred.

Costs to Fulfill a Contract

4. The compensation of employees assigned to the advisory engagement are direct costs of fulfilling the advisory contract. In addition, out-of-pocket expenses may be incurred as part of performing the advisory service. Customary out-of-pocket expenses incurred in connection with fulfilling an advisory contract may include travel (e.g., airfare, hotel, and meals), fees for external legal counsel and other professional advisors and fees related to business information services (e.g., market/industry research), (collectively “out-of-pocket expenses”).
5. A broker-dealer should evaluate if compensation and out-of-pocket expenses incurred to fulfill an advisory contract should be deferred and recognized as an asset. FASB ASC 340-40-25-5 states that an entity shall recognize an asset for the costs incurred to fulfill a contract only if those costs meet all of the following criteria:
 - a. The costs relate directly to a contract or an anticipated contract that the entity can specifically identify,
 - b. The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) future performance obligations, and
 - c. The costs are expected to be recovered.
6. FinREC believes that the first criterion for cost capitalization in FASB ASC 340-40-25-5 is generally met in a typical advisory contract. The terms and conditions under which the broker-dealer is engaged to provide services are documented in an advisory contract between the broker-dealer and the customer. A portion of the compensation of employees assigned to work directly on the advisory engagement are direct costs of fulfilling the advisory contract. The out-of-pocket expenses incurred as part of performing the advisory services relate directly to the specific advisory contract between the entity and customer.
7. In regards to the second criterion for cost capitalization in FASB ASC 340-40-25-5, the compensation of employees assigned to work directly on the engagement and out-of-pocket expenses incurred in connection with performing the advisory work are costs that may generate or enhance resources used to provide advisory services to the customer, depending on whether the advisory service is satisfied over time or at a point in time. For example, as there may be litigation risk associated with certain advisory transactions, outside legal counsel may be engaged to represent the broker-dealer and assist with activities such as reviewing and drafting the fairness opinion, reviewing all transaction-related documents and drafting proxy statements related to the deal. The work performed by the employees and additional resources (e.g., legal advice, market research, and travel costs) all help the broker-dealer build the requisite knowledge (intangible benefit) needed to inform its views and provide sound advice to the customer. If the requisite knowledge is used to satisfy future performance obligation(s), these costs meet this criterion to be capitalized as an asset, as they generate or enhance resources of the entity that will be used to satisfy a future performance obligation. However, in situations where the costs incurred are related to satisfied performance obligations (often the case if a performance obligation is satisfied over time as opposed to at a point in the time in the future), the second criterion for the costs to be capitalized is not met. Therefore, costs that are incurred to satisfy performance obligations over time shall be expensed as incurred. This is consistent with Basis of Conclusion (BC) 308 of ASU 2014-09, which states that only costs that meet the definition of an asset are recognized as such and that an entity is precluded from deferring costs merely to normalize profit margins throughout a contract by allocating revenue and costs evenly over the contract period.

8. In regards to the third criterion for cost capitalization in FASB ASC 340-40-25-5, an entity can expect to recover costs incurred to fulfill a contract through direct recovery (i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). FinREC believes this criterion generally will be met for out-of-pocket costs in arrangements in which these costs are explicitly reimbursable or otherwise expected to be recovered despite the success of the engagement, such as through a nonrefundable retainer fee or termination fee if the underlying transaction does not close. FinREC believes this criterion is not typically met for employee compensation costs, because, unlike out-of-pocket costs, compensation costs generally (i) are not explicitly reimbursable and (ii) may be sufficiently large that they would not be recoverable through up-front or termination fees despite the success of the engagement. Therefore recovery of such costs is dependent upon events and circumstances that are outside the control of the broker-dealer. This situation may indicate that sufficient evidence does not exist to support a conclusion that the costs are expected to be recovered. However, an entity should consider if the arrangement includes non-refundable fees that it expects to collect (e.g., retainer fee, termination fee) that may demonstrate the entity can recover these costs, or a portion of the costs, and therefore meet the recoverability criterion for capitalization up to the recoverable amount.
9. In summary, FinREC believes that out-of-pocket expenses typically will qualify for deferral and capitalization as an asset if the costs incurred are (i) related to performance obligations satisfied in the future and (ii) explicitly reimbursable or expected to be recovered despite the success of the engagement. However, compensation of employees assigned to work directly on the advisory engagement will not generally qualify for deferral and capitalization as an asset because, unlike out-of-pocket expenses, compensation generally are not explicitly reimbursable and may be sufficiently large that they would not be recoverable despite the success of the engagement. However, an entity should consider if the arrangement includes non-refundable fees that it expects to collect (e.g., retainer fee, termination fee) that may demonstrate the entity can recover these costs, or a portion of the costs, and therefore meet the recoverability criterion for capitalization up to the recoverable amount. The specific facts and circumstances of each arrangement should be considered when making these determinations.

Subsequent Measurement

Amortization and Impairment

10. In accordance with FASB ASC 340-10-35-1, when the broker-dealer incurs advisory costs that meet the criteria to be capitalized in accordance with FASB ASC 340-40-25-1 or 340-40-25-5, it should recognize an asset on the statement of financial condition and amortize it on a systematic basis consistent with the transfer to the customer of the advisory services to which the asset relates. See the related Broker-Dealer Issue 3-5, Investment Banking Advisory Fees, which describes circumstances where advisory fees may be recognized over time or at a point in time, depending on the nature of the underlying services. Conclusions related to the nature of the advisory services and the resulting pattern of revenue recognition for the advisory fees will impact the amortization pattern of capitalized costs. For fees recognized at a point in time, any related capitalized costs should be amortized in full on that date. Additionally, in accordance with FASB ASC 340-10-35-3, costs capitalized in accordance with FASB ASC 340-40-25-1 or 340-40-25-5 are tested for impairment by comparing the carrying amount of the capitalized costs to an amount that considers the revenue and costs that remain to be recognized under the contract.

Presentation

11. When another party is involved in providing goods or services to a customer, the broker-dealer should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the broker-dealer is a principal) or to arrange for those goods or services to be provided by the other party (that is, the broker-dealer is an agent). To apply the principal versus agent guidance, a broker-dealer must first properly identify the specified good or service to be transferred to the customer. Refer to paper 3-5, Investment Banking Advisory Fees, for guidance on defining the performance obligation(s).
12. A broker-dealer should apply the guidance in FASB ASC 606-10-55-37A and 55-39 to determine if it controls the specified good or service before it is transferred to the customer and is therefore acting as principal. In accordance with FASB ASC 606-10-55-37B, reimbursable advisory costs should be presented gross when the broker-dealer is acting in a principal capacity and in accordance with FASB ASC 606-10-55-38 presented net (i.e., contra revenue) when the broker-dealer is acting in an agent capacity.

13. FASB ASC 606-10-55-37A indicates that when another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:
 - a. A good or another asset from the other party that it then transfers to the customer
 - b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf
 - c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer.

14. A broker-dealer incurs out-of-pocket expenses as part of providing advisory services to the customer. The out-of-pocket expenses pertain to services that help the broker-dealer build the requisite knowledge needed to perform under the advisory engagement. The broker-dealer uses these services and combines them with other services as part of delivering on its performance obligation to provide advisory service to the customer as discussed in FASB ASC 606-10-55-37A(c).

15. Additionally, FASB ASC 606-10-55-39 provides indicators that an entity controls the specified good or service and is acting as principal. FinREC believes a broker dealer would evaluate these indicators as follows:
 - a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service –

The specified service is the advisory service agreed to in the contract between the broker-dealer and customer. FinREC believes this criterion is met as the broker-dealer is the party responsible for fulfilling the promise of providing the advice to the customer. The broker-dealer separately engages and contracts with third party service providers such as law firms, airlines and hotels, and in doing so is not acting as an agent between these providers and the customer.

 - b. The entity has inventory risk before the specified good or service has been transferred to a customer or after that transfer –

FinREC believes this criterion is not met. The broker-dealer does not commit to obtain the services from the supplier before entering into a contract with the customer.

 - c. The entity has discretion in establishing prices for the specified good or service –

FinREC believes this criterion is met as the broker-dealer has discretion in establishing the fee for the services from the third party suppliers (e.g., law firms engaged for the advisory services by the broker-dealer). That is, the broker-dealer could cover the third-party supplier fees by charging a direct reimbursement fee or cover them by charging a higher overall advisory services fee.

16. FinREC believes the broker-dealer generally is acting as principal and consequently, in accordance with FASB ASC 606-10-55-38, the reimbursable costs incurred to fulfill the advisory contract should be presented as revenue and expense in the gross amount of consideration to which it expects to be entitled. FinREC believes this because (i) the broker-dealer obtains control of these services and combines them with other services as part of delivering on its performance obligation as discussed in FASB ASC 606-10-55-37A(c), and (ii) based on the weight of the indicators in FASB ASC 606-10-55-39. However, the specific facts and circumstances of each arrangement should be considered when making this determination.

Comments should be received by May 1, 2017, and sent by electronic mail to Ivory Bare at ivory.bare@aicpa-cima.com, or you can send them by mail to Ivory Bare, Content Development, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.