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The New Revenue Recognition Standard: Guide for Asset Managers

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In an effort to address concerns surrounding the inconsistencies and weaknesses in existing accounting for revenue transactions, Accounting Standards Codification 606, Revenue from Contracts with Customers, ("ASC 606"), establishes a principles-based approach for revenue recognition (regardless of industry or geography).

The new guidance will:

- **Provide for a more standardized foundation for addressing revenue issues;**
- **Improve comparability of revenue recognition across entities;**
- **Provide more useful information to financial statement users through improved disclosure requirements;**
- **and simplify the preparation of financial statements by reducing the number of requirements to which an organization must refer.**

Although, the impact of adoption of the new standard may vary between entities, asset managers will need to re-evaluate fee arrangements under which services are provided to determine accounting changes that will need to be implemented.

Those fee arrangements include:

- **Management fees, unitary management fees and related fee waivers and expense caps;**
- **Incentive or performance fees, including carried interest;**
- **Reimbursement of startup or ongoing costs;**
- **Distribution and related fees, such as fees paid out of fund assets to cover marketing and selling fund shares (12b-1 fees)**

Transitioning to the New Standard

The standard allows for either full retrospective or modified retrospective adoption methodology.

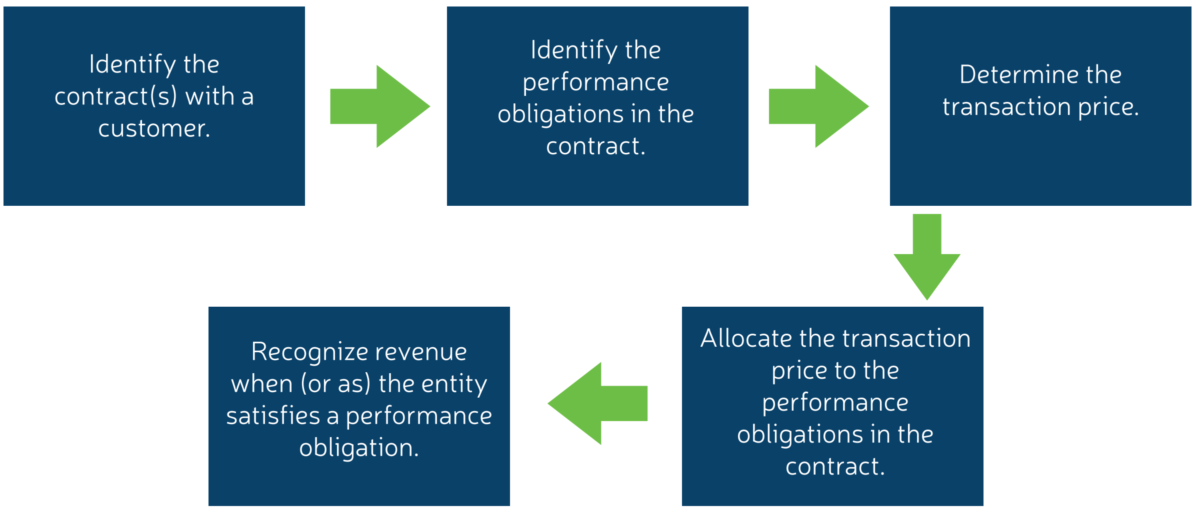
Under the full retrospective approach, ASC 606 requires determining the cumulative effect of applying the new standard as of the beginning of the first historical period presented, and a comprehensive recasting of the prior year's financial statements as if the new guidance had always existed for a comparative two-year period prior to the year of adoption. The full retrospective approach may be preferable to provide consistency and comparability between periods.

Under the modified retrospective approach, entities should apply the amendments to the new standard to all new contracts initiated on or after the effective date. For contracts which have remaining obligations as of the effective date, a cumulative catch up adjustment to opening balance equity should be computed and recorded. This approach can be more cost-effective and less time intensive as it does not require a high volume of data to recast the accounting for prior periods. However, it requires an entity to maintain two sets of accounting records in the year of adoption to meet expanded footnote disclosure requirements.

The Core Principle of ASC 606

The core principal of the new standard is to "recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

In order to achieve the core principle, entities should apply the following five steps:



Application of the Five-Step Model as it relates to Asset Management

Step 1: Identify the Contract with a Customer

ASC 606 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." The contracts can be written, oral, or electronically produced.

Under ASC 606, asset managers should combine contracts if:

- **Two or more contracts entered into at or near the same time with the same customer are negotiated as a package with a single commercial objective;**
- **The amount of consideration paid in one contract depends on the price or performance of another contract;**
- **The goods or services promised in the contracts are a single performance obligation**

Who is the customer?

An asset manager typically enters into contracts with funds (investment pooling vehicles), which allow investors to benefit from an asset manager's services, raising the question as to which party would be considered the customer, the fund itself or the investor.

This determination could affect the following:

- **The timing of revenue recognition:** For example, if an asset manager has multiple contracts or promises in a contract, that would either be accounted for separately or together, depending on who the customer is for each individual contract or promise.
- **The accounting for certain costs:** For example, costs associated with launching a new fund or obtaining new investors could be either expensed as incurred or capitalized depending on whether they are associated with obtaining customers or fulfilling performance obligations.

Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") board members concluded that given the wide variety of structures, there is no single determinative factor when identifying the customer in relation to the revenue recognition guidance, leaving it up to each entity to be thoughtful about the specific facts and circumstances of each arrangement and apply a consistent approach in performing the evaluation.

The following indicators have been developed by the Financial Reporting Executive Committee ("FinREC") for use by the asset management industry and may be used as a framework to assist preparers in applying judgment to their specific facts and circumstances. The existence or absence of any one indicator should not be considered final.

Indicators that the fund is the customer include:

- **The fund is a separate legal entity that may be set up as a partnership, corporation, or business trust**
- **The fund is governed by a board of directors or other form of governance, which is independent of management of the fund**
- **Fee arrangements for management and advisory fees are negotiated by the fund and applied consistently by the investor class**
- **A large number of potentially diverse investors is an indicator that the asset manager's relationship is more directly with the fund**
- **The fund lacks visibility as to who the ultimate investor is because investors have subscribed through a third-party broker-dealer's omnibus account**
- **The fund is highly regulated, as is the case with registered investment companies in the U.S.**

These characteristics are common in a mutual fund.

Indicators that the fund investor(s) is the customer include:

- **The asset manager enters into individual "side letter" arrangements regarding management fees with individual investors (as may be common in certain partnership structures)**
- **There is active negotiation of fees or interaction between the asset manager and individual investors or a small group of investors that control the fund's activity directly or indirectly through their role on the board or governing body (that is, the investors as a group act together as the fund's governance structure)**
- **The fund is not governed by a board of directors or other form of governance, which is independent of management of the fund**
- **There is a single or a limited number of investors, where the investor(s) has influence over the service arrangements.**

These characteristics are common in a private fund, such as a hedge fund.

Step 2: Identify the Performance Obligations in the Contract

Asset managers generally provide a number of services (performance obligations) to customers, these services may include, but are not limited to, investment advice, research services, overseeing the preparation of books and records, financial statement preparation, underwriting, distribution of fund shares and preparation, printing and distribution of prospectuses, reports and sales literature.

Determining which party is the customer is an important consideration in the unique asset management industry.

All arrangements will need to be analyzed to determine the goods and/or services the entity promises to transfer to a customer at contract inception. A good or service that is promised to a customer is distinct if the customer can benefit from a good or service either on its own or together with other resources that are readily available to the customer.

In certain cases, the asset manager may not need to enter into separate legal agreements with a customer as the fund's governing documents may explicitly state the services to be provided by the asset manager.

Step 3: Determine the Transaction Price

"The total transaction price is the amount of consideration the asset manager expects to receive for performing asset management services and includes both fixed and variable amounts." The idea of variable consideration applies to contracts where the revenue will be recognized over time rather than at a point in time.

Under ASC 606, variable consideration amounts must be estimated and included in the transaction price "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 example, the transaction price would include the periodic management fee at the end of the period when the fee is calculated based on end-of-period net asset value ("NAV") and will not include estimates of such management fees for future periods due to their significant variability.

Due to the significant variability of performance-based fees, these fees cannot be recognized until it is probable that a significant reversal of the cumulative amount of revenue recognized will not occur, such as upon crystallization at the end of the performance period or when the fees are no longer subject to a "clawback" adjustment. Additional factors could influence the determination of whether a significant reversal is probable, and the transaction price must be reassessed at every reporting date.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The purpose of allocating the transaction price is for an entity to allocate the transaction price to each performance obligation in an amount of consideration to which the entity expects to be entitled. In accordance with ASC 606, "the transaction price should be allocated to each performance obligation identified on a relative standalone selling price basis (determined as of contract inception), except as specified for allocating variable consideration."

Step 5: Recognize Revenue when (or as) the Entity Satisfies a Performance Obligation

ASC 606 states that "an entity should recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when (or as) the customer obtains control of that asset." Control by the customer would be attained either at a point in time or over time. It is up to the entity to assess whether the performance obligation is satisfied at a point in time or over time.

An entity should only recognize revenue for its performance if it can reasonably measure progress toward complete satisfaction of the performance obligation. The method used to measure progress should be based on reliable information. FinREC believes that a time-based measure of progress, 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.

Revenue Streams

Management Fees

In exchange for asset management services provided over the term of a contract, asset managers generally receive management fees from managed accounts or from funds. As the determination of management fees is tied to a measure of assets or capital, they are considered variable under ASC 606 as the fees earned are subject to fluctuation.

Under ASC 606, variable revenue streams should be recognized only when it is probable that the revenue generated will not change substantially when the uncertainty associated with the variable consideration is resolved.

Therefore, revenue generated from management fees can usually only be:

- **Included in the transaction price at the end of each reporting period;**
- **Allocated to each reporting period for which distinct services were provided.**

For example, if an asset manager earns management fees as a percentage of assets under management ("AUM") on a quarterly basis, the uncertainty would be considered resolved on a quarterly basis, as the fee is computed based on the AUM each quarter and is unrelated to the AUM of the previous or future quarter. From a Fund's perspective, a corresponding expense would be recorded at the same time that the manager recognizes revenue.

We recommend a firm to review their management fees allocation terms to ensure proper recognition under the new standard.

Unitary Management Fees

In a unitary management fee arrangement, an asset manager performs services associated with operations of the fund, including administrative functions, in addition to traditional asset management type services. As with management fees, the unitary management fee is typically calculated as a percentage of gross or net assets at a point in time or based on the average net assets over a given period. The same assessment that is used in traditional management fee arrangements applies to unitary management fee arrangements to determine whether the unitary management fee revenue would be presented as gross or net.

Fee Waivers

In certain instances, asset managers may waive a portion or all the management fees for a certain period of time. To determine the appropriate accounting treatment for fee waivers, asset managers should consider the following factors which affect the accounting treatment of fee waivers:

- **Timing of execution relative to fund or account establishment;**
- **Timing of execution relative to services rendered;**
- **Whether the fee waiver is a flat fee waiver or pertains to an expense cap**

Incentive or Performance Fees

Entities that receive performance-based incentive fees or allocations may see the most significant impact of ASC 606.

Due to market volatility, variable consideration in the form of performance fees should be excluded from the transaction price until it becomes probable that there will not be a significant reversal of cumulative revenue recognized.

In making this assessment, asset managers should consider the following factors:

- **The extent to which the underlying investment portfolio is subject to future changes**
- **The extent to which there is a return on investment in excess of the contractual hurdle rate**
- **The time remaining in the performance period**

Asset managers should also consider the specific terms of the contract and any unique facts and circumstances of the arrangement when determining the performance obligation to which the customer's payment of performance fees relates.

If an incentive or performance fee is structured with a floor and a performance-based component, such as with fulcrum fees, or as a weighted average of performance over a period of several years, the uncertainty may only apply to a portion of the fee, which could result in partial recognition.

Incentive or Performance-Based Capital Allocations

Incentive or performance-based capital allocations, including carried interest, are arrangements where an incentive or performance fee is paid by re-allocating net earnings from the capital accounts of the non-managing interest holders to the asset manager's capital account when returns exceed contractual thresholds.

Incentive or performance-based capital allocations may also include "clawback" or other similar provisions, which could affect the timing of distributions or require repayment of previously distributed amounts.

It is our view that under ASC 606, investment managers will be required to delay recognition of revenue related to incentive or performance fees and allocation until they crystalize at the end of the performance period or are no longer subject to a "clawback" adjustment; at which point it would be probable that a significant reversal of cumulative revenue recognized would not occur.

From a Fund's perspective, a reallocation of profits from non-managing interest holders to the asset manager's capital account would be recorded at the same time that the manager recognizes revenue.

A timing difference could be present between the asset manager and a private equity fund that it manages, whose incentive allocation crystalizes only upon the sale or other disposition of investments. For example, a private equity fund provides for an incentive allocation only upon the sale of investments. As of its fiscal year end (i.e. 12/31/20XX), the fund has yet to dispose of any investments, even though fair values have appreciated since purchase. Under ASC 606, the investment manager has determined that the incentive allocation does not meet the criteria for revenue recognition on its books and records due to the probability that a significant reversal of the incentive may occur upon sale of investments. On the fund's end, investment company accounting guidance requires the fund to recognize revenue related to incentive allocation on the reporting date "as if" the fund has liquidated all assets at current fair value, and the incentive allocation was due on that date. Accordingly, at 12/31 the fund in this example would record an incentive allocation because its investments had appreciated in value and if it were to liquidate on that date an incentive allocation would be payable to the investment manager.

Costs of Managing Investment Companies

Asset managers incur various costs to establish the investment company, raise capital from potential investors, or pay for costs incurred in the ordinary course of performing services for the customer as disclosed in the Investment Management Agreement.

Incremental costs of obtaining a contract with a customer are those that would not have been incurred if the contract had not been obtained. Costs to fulfill a contract are those that relate directly to an existing contract or a specified anticipated contract.

The following table summarizes FinREC's views on certain common costs incurred by asset managers:

Costs Incurred	Customer: Investment Company	Customer: Investor
Sales commissions paid to the asset manager's wholesalers (employees)	Not an incremental cost to obtain a contract, as these costs are not related to obtaining the contract with the investment company. Assess the costs under the guidance for costs to fulfill a contract.	Capitalize Non-discretionary sales commissions as an incremental cost of obtaining a contract if expected to be recovered.
Sales commissions paid to third-party broker-dealers	Not an incremental cost to obtain a contract, as these costs are not related to obtaining the contract with the investment company. Assess the costs under the guidance for costs to fulfill a contract.	Capitalize nondiscretionary sales commissions as an incremental cost of obtaining a contract if expected to be recovered.
Placement fees	Not an incremental cost to obtain a contract, as these costs are not related to obtaining the contract with the investment company. Assess the costs under the guidance for costs to fulfill a contract.	Capitalize as an incremental cost of obtaining a contract if expected to be recovered.
Asset allocator fees	Not an incremental cost to obtain a contract, as these costs are not related to obtaining the contract with the investment company. Assess the costs under the guidance for costs to fulfill a contract.	Not an incremental cost to obtain a contract, as these costs are paid regardless of whether investors invest in the asset manager's sponsored investment company. Assess the costs under the guidance for costs to fulfill a contract.

The following are examples of revenue-related items that fall outside of the scope of ASC 606:

- **Interest and dividend income**
- **Premium and discount amortization**
- **Realized and unrealized gains from investment securities and financial instruments (including debt and equity securities, private placements, investments in other funds and derivative contracts including options, futures, swaps and forward contracts).**
- **Mortgage servicing income**
- **Loan prepayment fees**
- **Loan late fees**
- **Loan origination fees**
- **Loan commitment fees**
- **Income from lease contracts**

Impact of ASC 606 on Private Equity/Venture Capital Firms

Under the new standard, private companies will need to apply the five-step model to a transaction to determine when to recognize revenue and the transaction amount to be recorded. The new rules are principles-based and in some cases, determination might require legal opinions.

As it may be impractical for a company to analyze every single contract, private companies may select a representative sample of contracts, with the same transaction attributes, to assess the appropriate accounting treatment under ASC 606. Once decisions are made on how to apply ASC 606 to those specific contracts, private companies will need to apply any conclusions reached to all similar contracts, given that the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts.

When estimating the fair value of investments in portfolio companies, there may be impacts to valuation depending on how the fund values its portfolio companies; for example, if an EBITDA multiple is used, or a discounted cash flow model, or a comparable company analysis. Shifts in revenue could have a direct effect on the valuation. The possible impact to fair value estimates must be carefully considered.

The timing of revenue recognition has a direct effect on the amount of profits available for allocation, which in turn can influence the carried interest calculation and therefore any "clawback" provisions.

In addition, the allocation of management fees should be reviewed. If management fees are waived or offset and carried forward to a future period, ASC 606 will be applicable.

As a firm adopts ASC 606, it may have to delay recognizing revenue that it previously recognized up front. Delaying revenue recognition could require a change in debt covenants.

Impact of ASC 606 on Real Estate Companies

The real estate industry will see changes in how revenue is recognized and will need to modify the revenue recognition processes in their organization. The new revenue standard affects how operating real estate entities must account for sales of real estate to service arrangements with customers.

Under ASC 606, revenue is recognized when a performance obligation is satisfied, which occurs when control of a good or service (such as a real estate property) transfers to a customer. Depending on the circumstances, revenue should be recognized over time or at a specific point in time.

Below are some considerations for real estate transactions:

- **Gains and losses on real estate sales will be recognized when title transfers to the customer;**
- **Costs incurred for model units, advertising and sales overhead are unlikely to qualify for capitalization under ASC 606;**
- **Most developer fees from third parties or investees will be recognized over a period of time, rather than at a point in time;**
- **Fees for property management and other services may be recognized differently due to the new requirements to estimate variable consideration and to determine the number of performance obligations contained in the contract.**

The accounting for management fees and other fees that vary based on performance (e.g., percentage of the property's revenues or net operating income) will also change. A property manager will have to estimate, at contract inception, the variable consideration to which it will be entitled and for which it is probable that a significant revenue reversal will not occur. This amount will then be recognized in the period as the performance obligation is satisfied.

Operational Expenses

Some of the operating services over which the asset manager is responsible for paying may be performed primarily during a particular time or times of the year, for example, audit and legal services and regulatory filing services. In addition, payment for these services may only be made at these times. However, there are typically aspects of such services that are performed throughout the year, as other asset management-related services are performed. FinREC believes that it is reasonable to conclude that each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day.

Costs to launch a new investment vehicle (commonly referred to as "organization cost") are required to be expensed as incurred.

Amortization and Impairment

Costs capitalized under FASB ASC 340-40 Other Assets and Deferred Costs – Contracts with Customers ("ASC 340-40") should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. An asset manager will need to utilize judgment when determining a systematic basis for amortization. A systematic basis will generally include determining the expected period of benefit of the asset, which may be measured using average customer life, term of the investment company (if definite-lived), or another basis that is consistent with the transfer of the investment management services provided.

As a practical expedient, ASC 340-40 states that an entity may expense incremental costs to obtain a contract as incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

ASC 340-40 states that an entity should recognize an impairment loss in earnings if the carrying amount of an asset exceeds its recoverable amount. Under ASC 340-40, the recoverable amount equals the remaining amount of consideration the entity expects to be entitled to in exchange for the goods or services associated with the capitalized contract costs, minus the costs directly related to those goods or services.

Footnote Disclosures:

In order to provide financial statement users with comprehensive information regarding the entity's major revenue streams, ASC 606 requires enhanced footnote disclosures.

An entity should disclose information about the following:

- **Disaggregated revenue:**
  - **Nonpublic entities may elect not to apply the quantitative disaggregation of revenue; however, at a minimum must disclose:**
    - **Revenue disaggregated according to the timing of transfer of goods or services (for example, at a point in time and over time)**
    - **Qualitative information about how economic factors (for example, type or geographical location of customers or type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows**
- **Reconciliation of contract balances**
  - **A nonpublic entity may elect to disclose only the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with its customers.**
- **Performance obligations**
  - **An entity must disclose information about its performance obligations in contracts with customers, as follows:**
    - **When the entity typically satisfies its performance obligations;**
    - **The significant payment terms;**
    - **The nature of the goods or services that the entity has promised to transfer;**
    - **Obligations for returns, refunds, and other similar obligations;**
    - **Types of warranties and related obligations**

Additional disclosures for remaining unsatisfied or partially satisfied performance obligations are optional.

- **Significant judgments**
  - **Nonpublic entities must disclose the following:**
    - **The methods used to recognize revenue for performance obligations satisfied over time;**
    - **The methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.**

Stay on the look out for Richey May's release of the 2019 Financial Statements templates, which will include footnote examples pertaining to the new revenue recognition standard.

If you have additional questions about the adoption of ASC 606, Richey May's professionals in the Alternative Investments practice are available to help.

For more information, please contact Stephen Vlasak or visit our website.