

Technical Line

FASB – final guidance

How the new revenue standard affects asset managers

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What you need to know

- ▶ Asset managers need to make a number of judgments on when and how to recognize performance-based fees for their investment management services. This may result in entities recognizing revenue differently than they have in the past.
- ▶ Certain expenses incurred by the asset manager that are reimbursed by funds or investors may be required to be presented gross on the income statement (i.e., in revenue and expense) based on the asset manager's performance obligations and principal versus agent evaluation.
- ▶ Asset managers may be required to capitalize certain contract costs (e.g., placement fees, implementation costs), amortize these assets and analyze them for impairment. This is a change in practice for entities that have not previously capitalized these costs.

Overview

The new revenue recognition standard issued¹ by the Financial Accounting Standards Board (FASB or Board) requires entities in the asset management industry to make additional judgments and estimates, such as when and how to recognize performance-based fees for their investment management services.

This publication highlights key aspects of applying the FASB's standard to an asset management entity's contracts with its customers, addresses significant changes to legacy practice and reflects the latest implementation insights.

As a reminder, the FASB deferred² the effective date to annual periods beginning after 15 December 2019 and interim periods in annual periods beginning after 15 December 2020, for entities that had not yet issued (or made available for issuance) financial statements that reflected the standard as of 3 June 2020 (i.e., certain private and not-for-profit entities). Early adoption is permitted. The deferral is intended to give these entities more time to implement the standard, given the operational and financial reporting challenges of the COVID-19 pandemic. Public entities, as defined by the standard, and some private and not-for-profit entities were already required to adopt the standard.

This publication, which contains a summary of the standard in the Appendix, supplements our Financial reporting developments (FRD) publication, [*Revenue from contracts with customers \(ASC 606\)*](#), and should be read in conjunction with it. The views we express in this publication may continue to evolve as implementation continues and additional issues are identified.

Asset management entities should also keep in mind that, when they adopt the new credit impairment standard,³ they will need to estimate full lifetime expected credit losses for their accounts receivable and contract assets. As a reminder, they will need to do this after assessing collectibility under the revenue guidance to determine whether they have a contract with a customer. Refer to our FRD publication, [*Credit impairment for short-term receivables under ASC 326*](#), for more information.

For a discussion of how to apply the standard to broker-dealer arrangements, see our separate Technical Line, [*How the new revenue standard affects brokers and dealers in securities*](#). For a discussion of how to apply the standard to asset servicing and other banking services, see our separate Technical Line, [*How the new revenue standard affects banks*](#).

Background

Asset managers typically enter into contracts to provide advisory and other services to investment vehicles, such as hedge funds, private equity funds and mutual funds, and to separately managed accounts for individual investors.

While the legal forms of the arrangements vary, the investment vehicles generally provide for investor capital to be pooled and invested to earn a return. Hedge funds typically do not have stated lives and allow investors to subscribe to and redeem their investments from the funds at specified dates. Private equity funds generally have stated lives (e.g., 10 years), and investors that commit capital to a fund cannot voluntarily redeem their investments during this period. Both hedge funds and private equity funds typically pay base management fees and performance-based fees to the asset manager that may serve as the general partner, investment manager and/or adviser.

US mutual funds (mutual funds) typically do not have stated lives and generally do not pay performance-based fees. Mutual funds have added complexities because they also often have agreements with distributors, brokers and other service providers. Mutual funds are subject to the Investment Company Act of 1940 and are overseen by a board of directors.

Separately managed accounts often do not have stated lives, and investors pay management fees and may pay performance-based fees for investment services.

Fee arrangements for hedge funds, private equity funds, mutual funds and separately managed accounts that should be evaluated under the standard include:

- Base management fees and related fee waivers and expense caps

- ▶ Performance-based fees
- ▶ Reimbursement of ongoing costs
- ▶ Distribution and related fees

Investment management arrangements

Identifying the contract with a customer

To apply the new model, an asset manager must first identify its contract(s) and customer(s). Any arrangement between an asset manager and a customer (e.g., limited partnership agreement, management agreement, fund prospectus) that creates enforceable rights and obligations is considered a contract under the standard. The identification of the customer also will affect the asset manager's accounting for up-front fees and certain costs. The AICPA Audit and Accounting Guide: *Revenue Recognition* has identified several factors an asset manager may consider in identifying the customer, although both the purpose and design of the arrangement should be considered in evaluating this conclusion. Examples of the most typical factors include the following:

The fund may be the customer when:	The investor may be the customer when:
The fund is governed by a board of directors (or other form of governance) that is independent of management of the fund.	The fund is governed by the decisions of the investors (e.g., the investors have the direct ability to terminate the manager of the fund).
The fees are consistent by investor class.	The fees are specific to individual investors (e.g., side letters exist for individual investors).
The asset manager negotiates the contracts and fees directly with the fund or its governing board.	The asset manager negotiates the contracts and fees with individual investors (or a small group of investors).
The number of unrelated investors is large.	The number of unrelated investors is small.

Identifying the customer will affect the accounting for up-front fees and certain costs.

Consider a mutual fund. It is a regulated legal entity that has a board of directors that includes independent members who must periodically approve certain matters, and it has a relatively large number of investors (i.e., shareholders). A mutual fund generally has no employees. Instead, it contracts with parties to obtain services.

A mutual fund typically contracts with an asset manager to obtain investment advisory services for the benefit of the shareholders. The mutual fund negotiates a fee for the services that is applied consistently to all shareholders within each share class. It may be reasonable to conclude that the mutual fund (and not the mutual fund's shareholders) is the adviser's customer. Contracts with a mutual fund to provide underwriting (distribution), custodian and transfer agent services may be evaluated similarly.

In contrast, consider a hedge fund established by a general partner (GP) for one limited partner (LP). The LP can negotiate investment advisory fees paid to the asset manager and has an active role on the fund's advisory committee. The fund has no governing body that is independent from the fund's management. In this case, it may be reasonable to conclude that the LP is the customer. Similarly, for separately managed accounts, the investor contracts directly with the asset manager and generally, the investor is the customer in these arrangements.

How we see it

The terms of an arrangement should be evaluated carefully to identify the customer. The proper identification of the customer is important because it can affect the accounting for fees from front-end sales loads and costs of obtaining a contract, among other things (see the Contract costs and Distribution services sections below for further discussion).

Combining contracts

The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if certain criteria are met (see Step 1 in the Appendix). For example, an asset manager of a hedge fund or a private equity fund that provides services to such a fund through a GP entity and an investment manager entity to which certain management functions are assigned likely will combine an investment management contract and GP contract because the contracts are negotiated together with a single commercial objective and the services promised in the contracts are generally a single performance obligation. That is, while there are separate contracts entitling the asset manager to different types and amounts of compensation, the general underlying service is the management of the fund's assets.

A mutual fund often enters into multiple contracts for advisory services, distribution and shareholder services, transfer agency services and custodian services, among others. In some cases, mutual funds enter into these contracts with the same service provider or service providers that are controlled by a common parent, and the contracts are entered into at the same time.

While the facts and circumstances would need to be evaluated to determine whether the contracts should be combined, it is likely that the individual, separate contracts would not be combined because:

- ▶ There are different commercial objectives for each service contract.
- ▶ There is generally no pricing interdependence between the contracts.
- ▶ The contracts contain separate performance obligations.

For example, we generally would not expect an asset manager that is both an adviser and an underwriter to combine an advisory contract and an underwriting (distribution) contract with the same mutual fund. The adviser contracts primarily to supervise and manage the fund's assets. In contrast, in a distribution agreement, the mutual fund contracts with a principal distributor that distributes the shares to the public directly or indirectly through other broker-dealers or financial intermediaries. As such, there are different commercial objectives for each service contract.

How we see it

Certain asset management contracts should be combined if the underlying services promised in the contract are a single performance obligation, even when the contracts have different types of fees (e.g., the management fee is based on net asset value (NAV) while the performance fee is based only on appreciation of NAV). Determining whether contracts should be combined will depend on the facts and circumstances and will require judgment. Although the requirement to combine contracts is generally consistent with the underlying principles in legacy guidance, asset managers need to carefully evaluate whether any of the criteria to combine contracts are met when applying the new standard.

Identifying the performance obligations

Investment management services

While asset managers often receive two separate forms of compensation (i.e., a management fee and a performance-based fee) under investment management contracts, they generally provide only one service of managing the investment fund's assets. That is, an asset manager generally does not offer either base management services or performance-based services separately, so they would not be separate performance obligations.

Goods or services that are part of a series of distinct goods or services that are substantially the same, are satisfied over time and have the same pattern of transfer to the customer should be combined into one performance obligation (see Step 2 in the Appendix). Certain services provided to investment funds (e.g., investment management services) are provided continuously over the contract period, so the services in the contract will generally represent a single performance obligation comprising a series of distinct service periods (e.g., quarters, months).

Example 25 in the standard⁴ illustrates this concept by describing a five-year investment advisory contract that entitles the investment manager to both a quarterly management fee and a performance fee that is based on cumulative results over the five-year term of the contract. The example concludes that the management services are a single performance obligation because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer.

Other services

Investment management contracts may include other services that are performed by asset managers (e.g., in-house accounting services) and services that asset managers arrange for third-party vendors to provide to the customer (e.g., audit and tax preparation services). Asset managers should critically evaluate the criteria for identifying performance obligations (e.g., whether the service is capable of being distinct and whether the promise to transfer the service is distinct within the context of the contract) to determine whether each service represents a separate performance obligation. This analysis is critical because each performance obligation is a separate unit of accounting.

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an asset manager must perform a principal versus agent analysis for each performance obligation to determine whether to record revenue on a gross or net basis. If an asset manager controls the services before they are transferred to the customer, it is acting as a principal and recognizes revenue on a gross basis. If the asset manager is arranging for the services to be provided by a third-party vendor to the customer, it is acting as an agent and recognizes revenue on a net basis.

An asset manager may use services provided by third-party vendors (e.g., investment due diligence services) as inputs to the investment management services it provides to its customer. Accordingly, the asset manager controls the services if it first obtains control of those services and directs their use to provide the combined output of the investment management services to the customer. When evaluating the indicators of control, the following could demonstrate that an entity controls a specified good or service before it is transferred to the customer:

- ▶ *The entity is primarily responsible for fulfilling the promise to provide the specified good or service.* The asset manager is responsible for providing the investment management services. Third-party vendors of the asset manager may contribute to the investment management service, but they are not primarily responsible for providing the service to the customer.

- ▶ *The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer.* The asset manager has inventory risk if it obtains the services from third-party vendors before the investment management services are transferred to the customer.
- ▶ *The entity has discretion in establishing the price for the specified good or service.* The asset manager determines the price of the investment management services and whether it is reimbursed for its costs incurred. The third-party vendors have no discretion in establishing the price for the investment management services that the asset manager agrees upon with the customer.

These indicators of control generally support a conclusion that the asset manager is the principal for the investment management services and the transaction price, including any cost reimbursements, allocated to the investment management services should be presented gross in revenue.

In other cases, the asset manager arranges for and pays third-party vendors to provide services to the asset manager's customer that are distinct from managing the customer's assets (e.g., audit and tax preparation services that aren't inputs to the investment management service). While the asset manager is reimbursed by the customer for these payments, its promise to the customer is to arrange to obtain services from a third-party vendor for the customer. When evaluating the indicators of control, the following could demonstrate that an entity does not control the specified good or service before it is transferred to the customer:

- ▶ *The entity is primarily responsible for fulfilling the promise to provide the specified good or service.* The third-party vendor is primarily responsible for fulfilling the promise to provide the specified good or service directly to the customer.
- ▶ *The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer.* The asset manager does not have inventory risk because it does not obtain the services from the third-party vendors before those services are transferred to the customer.
- ▶ *The entity has discretion in establishing the price for the specified good or service.* The price is determined in the customer's contract with the third-party vendor.

These indicators of control generally support a conclusion that the asset manager is acting as an agent and accordingly will net the cost of the services against revenue.

While the assessment of the indicators of control above would generally support that the asset manager is acting as an agent, the asset manager will need to perform a robust analysis of third-party vendor services to determine whether they are the principal or an agent in the arrangement. It is important to distinguish the expense reimbursement arrangements discussed in this section above from unitary management fee arrangements with mutual funds. In unitary fee arrangements, the asset manager enters into a management agreement with a mutual fund to provide services in exchange for a single all-inclusive fee. In these arrangements, the asset manager is responsible for the overall operation of the fund, and while some services may be delegated to third-party service providers by the asset manager, the asset manager is primarily responsible for fulfilling the overall obligation to the fund. The asset manager is responsible for directing the services provided by the third-party service providers and negotiating the terms and price of those services and has discretion in setting the price of the all-inclusive fee the customer pays. The performance obligation is the overall operation of the fund (e.g., inclusive of investment management, administration services, custody services, transfer agent services). Accordingly, the asset manager would generally be the principal in these types of arrangements.

An entity includes variable consideration in the transaction price only for amounts for which it is probable that a significant reversal of revenue will not occur.

Out-of-pocket reimbursements

Oftentimes, out of-pocket expenses such as travel expenses are incurred by an asset manager in fulfilling its investment management performance obligation. Direct reimbursement of these out-of-pocket expenses to the asset manager from its customer generally should be included in the asset manager's estimate of the transaction price in the contract to provide investment management services and should be recognized as revenue when the related performance obligation is satisfied.

Determining the transaction price

The transaction price is the amount of consideration to which the asset manager expects to be entitled for the transfer of services (e.g., investment management services) to the customer.

The standard requires an entity to estimate the amount of variable consideration to which it expects to be entitled and apply a constraint (see Step 3 in the Appendix). For base management fees based on each period's NAV, the transaction price will generally include the amount determined at the end of the period (e.g., amount based on average or end-of-period NAV). Entities may determine that the estimates of future period management fees will be constrained as the amount of consideration is highly susceptible to factors outside the entity's influence. However, irrespective of whether the management fees are fully constrained, the fees will generally meet the variable consideration allocation exception, which is described further in the next section.

Performance fees based on appreciation of a hedge fund's NAV or the realized appreciation of a private equity fund's investments are also variable consideration that would need to be estimated. However, in many cases, these estimated performance fees would be constrained because they are affected by changes in the fair value of the investment portfolio until they are crystallized (e.g., at the end of a hedge fund's performance period) or no longer subject to clawback (e.g., at or near the termination of the private equity fund). Under a clawback provision, a GP may be required to return certain distributions received from the fund for performance allocations if a specific performance threshold is not met.

Example 25 in the standard discusses a performance-based incentive fee that is based on a fund's return over a defined period and concludes that an estimate of the variable consideration, both at contract inception and at subsequent reporting dates, should be excluded from the transaction price because the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue will not occur. This is because the performance-based incentive fee has characteristics listed as factors in the standard that increase the likelihood and magnitude of a revenue reversal (e.g., the fee depends on the market and, thus, is highly susceptible to factors outside the entity's influence, the entity's experience with similar contracts has little predictive value). (See Step 3 in the Appendix.)

How we see it

Legacy GAAP allowed asset managers to recognize revenue based on the amount that would be due to the manager if the contract were terminated and the fund liquidated at the reporting date under what was known as Method 2. That method allowed asset managers to recognize performance-based fees earlier than entities that used legacy GAAP's Method 1, which required asset managers to wait until all contingencies had been resolved.

Because the new standard prohibits the recognition of variable consideration as revenue until it is probable that a significant reversal of the cumulative amount of revenue recognized will not occur when the uncertainty is subsequently resolved, entities that accounted for their variable incentive-based fees under legacy Method 2 and now apply ASC 606 generally will recognize these fees as revenue later under the new standard than they did under legacy practice.

The language in the constraint guidance (i.e., the use of the term “factors” rather than “criteria”) leaves open the possibility that, in certain circumstances, asset managers may need to recognize revenue from performance-based fees sooner than they would under legacy GAAP’s Method 1. The new standard does not provide specific guidance to make that determination. However, some factors an asset manager of a private equity fund might consider in concluding whether it is probable that a significant reversal of the cumulative amount of revenue recognized will not occur include whether:

- ▶ The fund is near final liquidation.
- ▶ The fair value of the remaining assets in the fund is significantly in excess of the threshold at which the manager would earn a performance-based fee.
- ▶ The probability of significant fluctuations in the fair value of the remaining assets is low based on the composition of the fund’s remaining assets.
- ▶ The fund’s remaining investments are under contract for sale with contractual purchase prices that would result in no clawback, and it is highly likely that the contracts will be consummated.

A manager might consider other factors in its assessment. No single consideration is determinative to conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur. This evaluation requires significant judgment and should be made based on the individual facts and circumstances. An asset manager that concludes that it is probable that some amount of the performance fee will not be reversed should include that amount in the transaction price. The transaction price is reassessed at each reporting date.

Illustration 1 – Determining the transaction price for an investment management contract

An asset manager provides services to a hedge fund through two wholly owned entities: a GP and an investment manager to which certain management functions are assigned. The investment manager earns a management fee that is invoiced and payable quarterly based on 0.5% of the fund’s ending NAV (i.e., a 2% annual fee). The GP is entitled to a performance-based incentive fee on 31 December of 20% of any year-over-year appreciation in the fund’s NAV. Assume that the GP agreement is in the scope of the new guidance, the GP does not consolidate the fund, and that there are no LP subscriptions or redemptions during the year.

Because the quarterly management fee and the annual performance-based incentive fee are determined by reference to NAV, they represent variable consideration. Considering various factors, including that the fees are subject to market volatility and a broad range of outcomes, assume that the GP and the investment manager are unable to conclude before the NAV is determined at the end of the quarter (for the management fee) and 31 December (for the performance-based incentive fee) that it is probable that a significant revenue reversal will not occur.

As a result, estimated performance fees expected to be earned for the rest of the year will not be included in the transaction price (i.e., they will be constrained). The estimated variable consideration is reassessed at each reporting date. Additionally, the entity determines that the management fee meets the variable consideration allocation exception, which is described further in the next section.

Assume that the fund's NAV at the beginning of the year is \$100,000. For simplicity, assume that the management fee is based on the end-of-quarter NAV, which is presented in the following table. As a reminder, the performance fee is receivable based on year-end NAV. The transaction price as of each quarter end could be calculated as follows:

Period	NAV	Management fee received	Calculated transaction price		
			Management fee	Performance fee	Total
Q1	\$ 100,000	\$ 500	\$ 500	\$ -	\$ 500
Q2	300,000	1,500	2,000	-	2,000
Q3	50,000	250	2,250	-	2,250
Q4	150,000	750	3,000	10,000	13,000

Allocating the transaction price to the performance obligations in the contract

Once the performance obligations have been identified and the transaction price has been determined, the transaction price is generally allocated to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). However, the standard provides an exception that allows variable consideration to be allocated to one or more distinct goods or services that form part of a single performance obligation if certain criteria are met (see Step 4 in the Appendix). Allocating the transaction price to the performance obligations or to the distinct goods or services that form part of a single performance obligation depends on the individual facts and circumstances of the contract.

Many asset management fees likely will qualify for the variable consideration allocation exception.

Many asset management fees likely will qualify for the variable consideration allocation exception because the variable consideration (e.g., management fees, performance-based fees) relates specifically to the entity's efforts to provide investment management services for a certain period within a contract (e.g., a month, a quarter) that are distinct from the services provided in other periods. As a result, any unconstrained variable consideration is allocated to the distinct periods instead of being spread over the asset management performance obligation. However, asset managers should evaluate any contract with unique payment terms that could suggest the allocation objective would not be met for that contract.

Asset managers may need to consider allocation of the transaction price based on relative standalone selling prices if there are multiple performance obligations (e.g., investment management services and administrative services) in the contract and the variable consideration allocation exception does not apply. However, if control is transferred for the other services in the same pattern and concurrently with the investment management services, it is not necessary to allocate the transaction price among the services as long as the fees for other services are presented in the same line item in the asset manager's financial statements.

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

An entity must determine whether it transfers control of a promised good or service over time or at a point in time (see Step 5 in the Appendix). Investment management services and other services performed by the asset manager generally are satisfied over time because the customer simultaneously receives and consumes the benefits provided by the asset manager as the asset manager performs the service. When a performance obligation is satisfied over time, the standard requires an entity to select either an input or an output method of measuring progress for each performance obligation that depicts the entity's performance in transferring control of goods or services to the customer. In many cases, an asset manager will determine that time elapsed (which could be an input method or an output method) best depicts its performance in transferring control of investment management services to the customer.

The standard provides a practical expedient that allows an entity to recognize revenue in the amount to which the entity has a right to invoice if that consideration corresponds directly with the value to the customer of the entity's performance completed to date (e.g., a services contract in which an entity bills a fixed amount for each hour of service provided).

Illustration 2 – Recognizing revenue when the entity satisfies a performance obligation

Based on the estimated transaction prices described in Illustration 1, management fees and performance fees will be recognized over time as follows:

Period	NAV	Management fee	Performance fee	Estimated transaction price at quarter end	Revenue recognized	
					New standard	Legacy Method 2
Q1	\$ 100,000	\$ 500	\$ -	\$ 500	\$ 500	\$ 500
Q2	300,000	1,500	-	2,000	1,500	41,500
Q3	50,000	250	-	2,250	250	(39,750)
Q4	150,000	750	10,000	13,000	10,750	10,750
				Total	\$ 13,000	\$ 13,000

Note: Under legacy Method 2, the \$40,000 (($\$300,000 - \$100,000$) x 20%) in performance fees would be deemed earned in the second quarter under a hypothetical liquidation of the fund and subsequently reversed in the third quarter due to a lower NAV. Under the new standard, the performance fee would not be included in the transaction price in the second quarter because, in the example, the entity was not able to assert that it is probable that a significant revenue reversal will not occur. This conclusion was discussed previously in Illustration 1. For purposes of this example, the pattern of revenue recognition under the new standard and legacy Method 1 is the same.

Carried interest

Performance-based fees may be paid in cash and/or through capital allocations (commonly referred to as carried interest). Because carried interest is a profit allocation and therefore may meet the definition of a financial instrument, some stakeholders had questioned whether US GAAP topics other than Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, might apply. During their 18 April 2016 meeting, FASB Transition Resource Group (TRG) members generally agreed⁶ that because a carried interest arrangement is designed to compensate an asset manager for its fund management services and because these arrangements do not differ in substance from other performance-based fee arrangements for which the asset manager would receive cash, it would be appropriate for them to be in the scope of ASC 606. The FASB agreed that it intended for these arrangements to be in the scope of ASC 606. Carried interest, therefore, would be included in the transaction price as variable consideration and recognized as revenue when it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur.

In certain fact patterns, the Securities and Exchange Commission staff has not objected to accounting for carried interest arrangements as financial instruments under topics other than ASC 606 (e.g., ASC 323, *Investments – Equity Method and Joint Ventures*). However, if an asset manager elects to account for a carried interest arrangement as a financial instrument, there are additional accounting and presentation considerations that need to be addressed, including whether the asset manager should consolidate the fund and how the income from the carried interest arrangement is presented on the income statement. If an asset manager changes its accounting principle under ASC 250, *Accounting Changes and Error Corrections*, for carried interest from revenue recognition under legacy Method 1 or Method 2 to a financial instrument approach, retrospective application of the new accounting principle is required in comparative financial statements and a cumulative effect adjustment, if any, is required to be recorded in opening retained earnings for the earliest period presented.

Whether carried interest can be accounted for under ASC 323 is based on an evaluation of the structure and legal form of the carried interest. For example, for fund structures where the asset manager's right to carried interest allocations is obtained through a legal form equity interest in a fund and the entity can exercise significant influence over the fund, accounting for carried interest under the equity method may be acceptable.

Contract costs

Costs to obtain and fulfill a contract

The standard provides guidance to account for an entity's costs incurred in (1) obtaining and (2) fulfilling a contract to provide goods and services to customers (see Contract costs in the Appendix).

Incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the costs are expected to be recovered. That means that the costs need to be explicitly reimbursable under the contract or reflected in the contractual price and therefore recoverable through margin. Asset managers may determine that certain placement fees paid to third-party vendors for obtaining new investors qualify for capitalization as costs to obtain investment management contracts if the investor is considered the customer. However, if the fund is identified as the customer, costs incurred to obtain a specific investor would not meet the capitalization criteria because they are not costs incurred to obtain a contract with the customer (i.e., the fund). Judgment is required to determine which costs should be capitalized as costs to obtain a contract when the fund is identified as the customer.

Formation and organizational costs to launch a new investment vehicle are not in the scope of the contract costs guidance in ASC 340-40, as ASC 720, *Other Expenses*, applies to these types of costs.

Generally, contract fulfillment costs incurred by asset managers (e.g., salaries paid to employees) are expensed as they are incurred, because they do not meet the criteria for capitalization (see Contract costs in the Appendix). For example, an asset manager's contract fulfillment costs likely will not generate or enhance resources of the entity that will be used to satisfy performance obligations in the future. The standard also states that costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e., costs that relate to past performance) should be expensed as incurred. In certain instances, costs may be incurred by the asset manager to satisfy a future performance obligation and may be capitalized provided that the costs are expected to be recovered and relate directly to a contract or to an anticipated contract that the asset manager can specifically identify (e.g., up-front implementation costs to onboard a new customer to the asset manager's platform in order for the asset manager to provide future investment management services to the customer).

Incremental costs of obtaining a contract or contract fulfillment costs that are capitalized should be amortized on a systematic basis consistent with the transfer to the customer of the services to which the capitalized costs relate. An asset manager should use judgment to determine the period of benefit and factors to consider might include average customer life, term of the fund or another basis consistent with the transfer of services to the customer. Asset managers may apply a practical expedient and expense as incurred incremental costs to obtain a contract if the amortization period is one year or less. Asset managers should also monitor any capitalized contract costs for impairment.

As discussed later in this publication, the FASB retained industry-specific guidance for certain distribution costs, which will continue to be capitalized.

How we see it

The accounting for the costs of obtaining a contract under the standard may change legacy practice for some entities. A key part of this analysis is properly identifying the customer. Certain costs may need to be capitalized, amortized and reviewed regularly for impairment.

Additional considerations for mutual fund asset managers

Distribution services

A mutual fund typically enters into a distribution agreement with a distributor to market and sell (collectively, distribute) shares. The distributor, in turn, often enters into agreements with broker-dealers or financial intermediaries who sell the shares to the public.

Funds typically offer multiple classes of shares, each of which has its own terms for the payment of distribution costs. Front-end load shares generally charge a sales load at the time of purchase, which is a percentage of the sales or offering price. Shares also may have a 12b-1⁵ fee or an ongoing fee that is based on NAV. Other shares have no front-end load but instead require payment of some combination of a higher 12b-1 fee and a contingent deferred sales load, which is paid if fund shares are redeemed before a stated number of years.

Distributors should consider the services promised in the distribution agreement and use judgment to determine whether there is a single performance obligation (e.g., sales and marketing services to distribute the shares) or multiple performance obligations (e.g., sales and marketing services to distribute the shares and shareholder services) and whether the performance obligation(s) is satisfied at a point in time or over time. A distributor's performance obligation to provide sales and marketing services to distribute shares would generally be satisfied at a point in time, while a shareholder servicing performance obligation would generally be satisfied over time.

When a distributor determines the transaction price, it should consider the following in evaluating whether 12b-1 fees and contingent deferred sales fees are constrained: (1) whether fees are based on the future market value of the fund's shares, (2) the length of time the investor will remain invested in the fund, (3) whether there is uncertainty about the amount that is not expected to be resolved for a long period and (4) whether there is a broad range of possible amounts.

Distributors of mutual funds often use sub-distributors to distribute a mutual fund's shares. A distributor will need to evaluate whether it is acting as a principal or an agent in these situations (see Step 2 in the Appendix). This assessment will be based on the specific facts and circumstances of the sub-distribution agreement.

Distribution costs paid by distributors

Sub-distributors often are paid by the distributor upon the sale of a share, including shares that do not have a front-end sales charge (on which the distributor will earn future 12b-1 fees). To avoid mismatches between revenue and expenses, mutual fund distributors defer and amortize incremental direct costs associated with the selling of the fund shares, including commissions paid to a sub-distributor.⁶ The new standard does not affect the industry specific guidance to account for these costs.

Advisory, custodian, administration and transfer agency services

Advisory, custodian and administration services often are provided pursuant to separate, one-year contracts, and the fees often are based on a percentage of NAV. A transfer agent generally contracts to maintain shareholder account records for the fund, handle certain communications between shareholders and the fund and pay certain dividends and distributions. The transfer agent often receives a monthly fee based on NAV or the number of shareholder accounts it maintains. In general, the revenue recognition considerations for each of these services are similar to those outlined previously for investment management services provided to a fund.

Fee waivers and expense reimbursements

An asset manager may voluntarily or involuntarily waive its management fee (fee waiver) or reimburse a mutual fund for expenses incurred in excess of a certain threshold, typically stated as a percentage of a fund's average net assets (expense cap).

An agreement to waive management fees or reimburse expenses may be entered into at the same time as the agreement to provide asset management services or separately negotiated at a later time. If the management fee waiver or expense reimbursement agreement is entered into at or near the same time as the asset management agreement, the two contracts likely would meet the contract combination criteria because the pricing of the contracts are interdependent. If the arrangement is separately negotiated at a later time, an asset manager likely will need to consider the contract modification guidance because the arrangement affects the transaction price of the related asset management contract. In either scenario, the contracts should be considered together for evaluating the amount and timing of revenue recognition.

Such fee waivers/expense reimbursements should be considered when the entity is determining the estimate of the related management fee or other fee (i.e., variable consideration), subject to the constraint. That is, the entity would include an estimate of the management fee, net of any reduction by a fee waiver or expense reimbursement, in the transaction price to the extent that it is probable that doing so would not result in a significant revenue reversal when the uncertainty is subsequently resolved. As a result, the estimated amount of fee waiver/expense reimbursement would be recognized as a reduction of management fee revenue when such management fee revenue is recognized. Consider the following example:

Illustration 3 – Recognizing management fee revenue when a fee waiver is granted at the inception of the asset management contract

An asset manager provides investment management services to a fund, charges an annual management fee of 1% of average daily net assets for its services and grants a waiver in the first year of the fund's operations of 0.2%. Assuming that the management fee and management fee waiver contracts are combined (pursuant to considerations discussed above), the fund would recognize revenue of 0.2% $[(1\% - 0.2\%)/4]$ at the end of each quarter during its first year of operation.

An asset manager also would account for a fee waiver/expense reimbursement as variable consideration if it determines that it intends to waive management fees or if it is the asset manager's customary practice to do so, even when an arrangement to waive management fees or reimburse expenses does not yet exist. In other words, an entity would estimate *expected* fee waivers/expense reimbursements as part of estimating the transaction price and recognize it as a reduction of management fee revenue when the related management fee revenue is recognized.

How we see it

Since management fees are variable consideration subject to the constraint, entities should carefully analyze their fee waiver and expense reimbursement arrangements to determine whether and when they can recognize management fee revenue. This evaluation may require significant judgment. For example, an entity that reimburses a fund for expenses incurred in excess of a certain threshold and has no reliable basis for estimating fund expenses (i.e., an entity has limited experience or its experience has limited predictive value) may have to defer recognition of management fee revenue until it has a reliable basis for estimating them (e.g., close to year end). That is because it may not be probable that a significant reversal of management fee revenue will not occur until that point.

Endnotes:

- ¹ Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, was created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, and various amendments.
- ² ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*.
- ³ ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.
- ⁴ ASC 606-10-55-221 through 55-225.
- ⁵ Fees authorized to be paid by a fund that has adopted a plan in accordance with Rule 12b-1 under the Investment Company Act of 1940.
- ⁶ ASC 946-720-25-4 (this was moved by ASU 2014-09 from ASC 946-605-25-8, which was preceded by Emerging Issues Task Force Issue No. 85-24, *Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge*).

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Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer
<p><i>Definition of a contract</i></p> <p>An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:</p> <ul style="list-style-type: none"> ▶ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations ▶ The entity can identify each party's rights regarding the goods or services to be transferred ▶ The entity can identify the payment terms for the goods or services to be transferred ▶ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract) ▶ It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer <p>If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.</p> <p><i>Contract combination</i></p> <p>The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:</p> <ul style="list-style-type: none"> ▶ The contracts are negotiated as a package with a single commercial objective ▶ The amount of consideration to be paid in one contract depends on the price or performance of another contract ▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation <p><i>Contract modifications</i></p> <p>A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:</p> <ul style="list-style-type: none"> ▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract ▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract ▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

Step 2: Identify the performance obligation(s) in the contract

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- ▶ The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct)
- ▶ The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted
- ▶ One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Series guidance

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

Customer options for additional goods or services

A customer's option to acquire additional goods or services (e.g., an option for free or discounted goods or services) is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its

role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

- ▶ The entity is primarily responsible for fulfilling the promise to provide the specified good or service
- ▶ The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return)
- ▶ The entity has discretion in establishing the price for the specified good or service

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

Variable consideration

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

Significant financing component

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

Noncash consideration

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

Consideration paid or payable to the customer

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity or equity instruments granted in conjunction with selling goods or services. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer

The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- ▶ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date

The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

Licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either:

- ▶ A right to access the entity's IP throughout the license period (a right to access)
- ▶ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use)

To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories:

- ▶ **Functional:** This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. However, we expect licenses of functional IP to meet the criteria to be recognized over time infrequently, if at all.
- ▶ **Symbolic:** This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP.

The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).

Contract costs

ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. ASC 340-40 cites commissions as a type of incremental costs that may require capitalization. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future
- ▶ The costs are expected to be recovered

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment.