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Impact of the New Revenue Recognition Standard on the Asset Management Industry

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Background:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers. Topic 606, Revenue from Contracts with Customers, presents the new revenue recognition guidance. FASB also issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, in August 2015. As a result of ASU 2015-14, the amendments in ASU 2014-09 are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein for public entities. Nonpublic entities should apply the amendments in ASU 2014-09 for annual reporting periods beginning after December 31, 2018, and to interim reporting periods within annual reporting periods beginning after December 15, 2019. Entities may elect to adopt early, and apply the amendments for an annual reporting period beginning after December 15, 2016 (the original effective date of ASU 2014-09).

The new standard will replace all industry-specific guidance currently available in U.S. generally accepted accounting principles ("GAAP") by applying five broad steps to determine when to recognize revenue. The guidance affects all entities that enter into contracts to provide goods or services to their customers, unless the contract type is specifically excluded from the guidance. The types of contracts that are excluded from Topic 606 include: lease contracts, insurance contracts, contractual rights or obligations for financial instruments, guarantees (other than service and product warranties), and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers.

Overview of Topic 606:
Topic 606 states, "The core revenue recognition principle is that revenue is recognized to depict the transfer of promised 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."

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Companies are required to apply the following steps to a transaction to determine when to recognize revenue and the transaction amount to be recorded:

Step 1: Identify the contracts with a customer.
By definition, a contract is an agreement between two or more parties that creates enforceable rights and obligations. Under the new revenue recognition policies, separate contracts will be considered a single contract if the contracts were negotiated as a single commercial package, consideration in a contract is dependent upon the other contract, or if the goods or services are a single performance obligation.

Step 2: Identify the performance obligations in the contract.
A performance obligation is defined as a promise to transfer a good or service under a contract with a customer. If the contract provides for the transfer of more than one good or service, the entity must determine whether each performance obligation is distinct. The performance obligation is deemed to be distinct if: (a) the customer can benefit from the goods or services on its own, and (b) the promises to transfer the individual goods or service are separately identifiable in the contract. Consideration must also be given to whether the goods or services are substantially the same and have the same pattern of transfer.

Step 3: Determine the transaction price.
The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. 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."

Step 4: Allocate the transaction price to the performance obligations in the contract.
Transaction prices are typically allocated to each performance obligation on the basis of the standalone selling prices of each performance obligation. If the standalone selling price is not apparent, an estimate must be used. Acceptable estimation methods include: the adjusted market assessment approach, the expected cost plus a margin approach, and the residual approach.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.
A performance obligation may be satisfied at a point in time, or over time, that will determine the timing of revenue recognition.

Impact on the Asset Management Industry
The implementation of Topic 606 and the five-step approach discussed above could have a significant impact on when asset managers recognize revenue. Asset managers typically earn revenues via two methods: management fees – generally charged as a percentage of assets under management ("AUM"), and incentive fees (or carried interest) – generally a

percentage of profits, subject to clawback provisions, hurdle rates, and high watermark provisions.

Management fees
For example, if an asset manager earns management fees as a percentage of AUM on a quarterly basis, although the transaction price is a variable amount, the uncertainty is resolved on a quarterly basis, as the fee is computed based on the AUM under management each quarter. It is our view that recognition of management fees as described above is consistent with current requirements under U.S. GAAP.

Performance-based fees
Under current U.S. GAAP, performance-based fees (i.e. incentive fees or carried interest) that are not finalized (and therefore clear) by the end of a reporting period can be recorded using one of two methods. Topic 605-20-S99-1 (formerly EITF D-96) discusses the two methods:

- Method 1: The manager does not record any incentive fee income until the amount to be recognized is finalized (i.e., in a private-equity fund, it might be at the end of the life of that fund, when all positions have been sold or liquidated).
- Method 2: The manager records the estimated incentive fee income based on what would be due under the contract on a "hypothetical liquidation" of all assets and liabilities at that reporting date.

Since performance-based fee contracts often include clawback and benchmarking provisions, which depend significantly upon market conditions, fees will be recognized under the new revenue recognition standards only when the uncertainties have been resolved and no significant reversal of recognized revenues is probable. The receipt of cash may not necessarily indicate recognized revenues under the new rules.

Because of the constraint on variable consideration discussed in Topic 606, asset managers who are currently using Method 2 will have a significant delay in the timing of recognition of performance-based fees.

On the other hand, asset managers who are currently using Method 1 may need to accelerate the timing of their revenue recognition, because Topic 606 includes a concept on assessing whether there is a "minimum amount of variable consideration" at each reporting period.

Upfront fees
Asset managers may obtain upfront fees from their investors for distribution services performed.

- If the distribution service is assessed as a separate performance obligation, the obligation is satisfied at the investor subscription, and the upfront fee will be recognized immediately (consideration during step 2).
- If the distribution function is assessed as being a supporting function of the management services, then it is not a separate performance obligation, but rather an advance payment for management services (consideration during steps 1, 2).

Asset managers must consider the specific facts and circumstances of each arrangement, and could be affected by whether the fund or the investor (i.e., the LP in the fund) is deemed to be the customer, and whether other services are performed by an entity within the same group as the asset manager. The transaction price should be allocated based upon the identified performance obligations established in the contracts.

Contract costs
If recovery of costs incurred relating to obtaining or fulfilling a contract is expected, these costs are recognized as an asset. These costs should:

- relate generally to a contract or to an anticipated contract that the entity can specifically identify;
- generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
- expect to be recovered.

Costs that are recognized as an asset must be amortized and reviewed regularly for impairment. Management must exercise judgement to determine the period over which to amortize these costs and when to analyze impairment considerations.

Next steps

Asset managers are encouraged to become familiar with the new revenue recognition standard and evaluate how the five-step approach will affect their systems, internal controls, policies, and practices. Entities should also discuss these changes with key stakeholders (owners, investors, lenders) so they can understand the impact of these changes to the financial statements (including increased disclosure surrounding revenue recognition, performance obligations, significant judgments, etc.).

WeiserMazars can help

Please contact your WeiserMazars Engagement Partner for an in-depth discussion of how these changes can affect your business.

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