



New revenue standard issued

Potential challenges in the asset management industry

The new revenue recognition standard will likely present challenges for many companies in the asset management industry, including accounting for performance-based and up-front fees.

Background

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update, *Revenue from Contracts with Customers* in May 2014. The standard provides companies with a single model for use in accounting for revenue arising from contracts with customers, and supersedes current revenue recognition guidance, including industry-specific revenue guidance. The core principle of the model is to recognize revenue when control of the goods or services transfers to the customer, as opposed to recognizing revenue when the risks and rewards transfer to the customer under the existing revenue guidance.

The effective date for public registrants has been deferred to 2018 for calendar year-end (annual reporting periods beginning after December 15, 2017). Early adoption as of the original effective date (2017 for calendar year-end) is permitted. The guidance permits companies to either apply the requirements retrospectively to all prior periods presented, or apply the requirements in the year of adoption, through a cumulative adjustment.

The delayed effective date and transition options are intended to allow companies a reasonable timeframe to comply. However, addressing some areas of the FASB Accounting Standards Codification may require longer lead-time, particularly related to revenue or billing systems where separation and/or allocation changes may be required, so companies should perform a preliminary analysis of the new requirements on a timely basis.

Considerations and challenges

The requirements in the standard will present complexity for many companies in the asset management industry. Examples of some of the challenges are as follows:

Performance-based fees — Investment manager fee arrangements may include performance-based fees that are calculated on the basis of the performance of the underlying assets being managed. Sometimes the performance of the underlying assets is evaluated against external factors such as a market index, and the fee arrangements may include complexities such as a high watermark or performance hurdles. Performance-based fees include carried interests and incentive fees.

In each reporting period, there may be uncertainty about the amount the investment manager will ultimately receive in performance-based fees until the fees are finalized or close to being finalized. In addition, performance-based fees paid to an investment manager may be subject to clawback provisions for underperformance in future periods. These clawback provisions may exist until the underlying assets are liquidated (which could be several years after the payment).

The SEC staff guidance in ASC 605-20-S99 (i.e., EITF D-96) provides two alternatives for recognizing performance-based

management fees. Accordingly, an investment manager elects an accounting policy to do either of the following:

- Defer recognizing performance-based fee revenue until the end of the contract (“Method 1”).
- Recognize revenue as of an interim date on which it is considered realizable because of termination provisions in the arrangement (“Method 2”).

While the ASU does not supersede the guidance in ASC 605-20-S99, it provides specific guidance on accounting for contracts that include variable consideration, i.e. arrangements whose consideration fluctuates based on the performance of an entity. Specifically, it indicates that the estimated variable consideration (or a portion thereof) is only included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of revenue recognized will not be subject to significant reversal. This concept is commonly referred to as the “constraint”. Entities may use judgment in determining whether to include variable consideration in the transaction price; however, the ASU notes that if the variable consideration is highly susceptible to factors outside the entity’s influence (including volatility in a market), it could be subject to significant future reversal¹.

Since an investment manager’s performance-based fees may be affected by the future performance of the underlying assets it manages, it is difficult to accurately predict how much of the performance-based revenue payable to the investment manager is not subject to future reversal until the fees are finalized or close to being finalized. Accordingly, the constraint on the amount of revenue that may be recognized as of a reporting date may significantly delay the timing of revenue recognition for these fees under the ASU when compared to an investment manager that currently applies Method 2.

Although the ASU could delay the recognition of these fees as revenue, the new guidance does not modify how investment managers should account for the associated costs (typically, compensation paid to employees). That is, although the revenue may be deferred until long after cash has been received by the investment manager, amounts distributed to employees may need

to be recognized as an expense in the period in which the amounts are incurred since they represent costs associated with fulfilling the contract².

As such, under the new guidance, an entity will need to use judgment and consider all facts and circumstances when assessing the risk that a subsequent change in an estimate of variable consideration would result in a significant revenue reversal. Entities should be aware that this assessment may require significant effort in order to create a process that ensures consistent policy application, including contract reviews and information gathering.

Up-front fees — To the extent an asset manager owns a broker that distributes sponsored products (i.e., front-end loaded distributions) there is generally an up-front fee (initial sales fee) that investors pay to the broker upon subscription to the fund. Under the new guidance, if the up-front fees are determined not to represent a separate performance obligation (i.e., not to result in the transfer of a promised service), revenue recognition would be deferred. This would be a change from current practice.

Contract combinations and modifications — The standard may require a company that enters into multiple contracts at or near the same time with the same customer to be accounted for as a single contract when the pricing or economics for those contracts are interdependent. These contracts would need to be evaluated together, in terms of determining separate performance obligations and in terms of allocating the transaction price. Also, adjustments related to contract modifications may be required. These changes may require some companies to enhance their contract management systems and tools.

Capitalization of costs to acquire customer contracts — The standard requires certain contract costs, including costs to acquire a contract with a customer (e.g., sales commissions), be capitalized and amortized. As a result, companies may need to develop or enhance process, controls, and systems to identify and account for such capitalized costs.

Disclosures — The disclosure requirements under the standard are significant and may require modification to financial

management reporting processes and systems. Additional disclosures include, but are not limited to, disaggregation of revenue, certain information about changes in contract asset and liability balances and contract costs, and information related to the amount of the transaction price allocated to performance obligations not yet satisfied.

Tax — Certain tax implications may arise as taxpayers often follow the financial reporting revenue recognition methods in the determination of taxable income and transaction tax obligations. The changes may have cash tax implications, may require federal tax accounting method changes, or give rise to new tax temporary differences that may need to be captured, calculated, and tracked through tax provision processes and systems. Taxpayers who do not follow financial reporting methods for tax may also need to consider the impact of these changes on tax reporting and may need to change their computations and procedures, as well as consider potential tax method changes. Similar implications may arise in foreign jurisdictions that impose tax based upon statutory reporting maintained under either International Financial Reporting

Standards (IFRS) or U.S. Generally Accepted Accounting Principles (U.S. GAAP), as this change may impact both standards.

Other implications

Organizations may need to consider other project needs, including:

- Implementation of updated or new processes, controls, and systems, where required
- Determination of new monthly closing process steps to accommodate the new requirements
- Steps to estimate the impact of the new standard, to facilitate understanding and planning by other key stakeholders
- Effective training and communication of new requirements
- Effective program and resource management related to this effort

Getting started

Some effective first steps to consider as you begin to evaluate the implications of the potential new standard may include:

- Evaluating significant revenue streams

and key contracts to identify the specific revenue recognition changes required and the specific business units where these changes may have the greatest impact

- Addressing the longer lead-time areas where new calculation rules or revised allocation processes may be required
- Establishing a granular project plan and roadmap to manage the effort across multiple business units and countries

How Deloitte Advisory can help

We have an experienced team of professionals, both in the U.S. and globally across the member firms of Deloitte Touche Tohmatsu Limited, who can assist in developing an action plan to help you implement the new revenue recognition standard.

These capabilities includes the full breadth of services and competencies needed to help clients address these issues, and would include accounting assistance, help with process revisions, support in making system changes (including development of system business requirements), tax and other matters.

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1 The SEC has indicated that it plans to review and update its revenue recognition guidance when the ASU is issued. The extent to which the ASU's guidance will affect a public entity will depend on how the SEC amends its guidance in EITF D-96 to be consistent with the new revenue standard.

2 While the ASU includes a scope exception for financial instruments that are within the scope of other ASC topics, it does not address whether carried interests are (1) revenue contracts within the scope of the ASU or (2) financial instruments that should be accounted for as equity-method investments. This issue may be addressed by the AICPA implementation group.



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