

# *In depth*

A look at current financial reporting issues



## ***Revenue from contracts with customers***

*The standard is final – A comprehensive look at the new revenue model*

## **Asset management industry supplement**

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### ***At a glance***

On 28 May, the IASB and FASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices.

*In depth 2014-02* is a comprehensive analysis of the new revenue standard. This supplement highlights some of the areas that could create the most significant challenges for entities in the asset management industry as they transition to the new standard.

### **Overview**

Revenue recognition in the asset management industry can be complex, as there are many variations of investment structures aimed at achieving returns or investment income for investors. Under the new revenue standard, the current IFRS and US GAAP industry-specific revenue recognition guidance will be superseded.

The impact of the new revenue standard will vary depending on an entity's existing accounting policies. Areas most affected could include, but are not limited to, up-front fees, up-front costs, and performance-based fees. Revenue recognised by an asset manager will now be subject to a constraint. The constraint limits revenue recognised to the amount for which it is highly probable (IFRS) or probable (US GAAP) that a significant reversal in the amount of cumulative revenue recognised will not occur in future periods. As a result, there may be changes in how revenue is recognised in the asset management industry.

This supplement focuses on how the standard will impact these arrangements for asset managers. The examples and related discussions are intended to provide areas of focus to assist entities in evaluating the implications of the new standard. Some of the key issues companies will need to address include identifying who their 'customer' is and identifying the separate performance obligations in the arrangement. These topics are explored in more detail below.

The new revenue standard is effective for the first interim period within annual reporting periods beginning after 15 December 2016 (for example, 1 January 2017 for an entity with a 31 December year end) under US GAAP. A one-year deferral will apply to non-public entities under US GAAP. The new revenue standard is effective for IFRS reporters for annual reporting periods beginning on or after 1 January 2017.



An entity has the option to apply the new standard retrospectively to all contracts or use a simplified transition method. Under the simplified transition method, an entity will (i) only apply the standard to existing contracts as of the effective date and to contracts entered into subsequently; and (ii) recognise the cumulative effect of applying the standard to existing contracts in the opening balance of retained earnings on the effective date. An entity will not restate prior periods if it uses the simplified transition method. Additional disclosure will be required for entities that choose to use this method, including the effect on each financial statement line item of applying the guidance in the initial year of application.

The new revenue standard does not include a specific scope exception for investment entities as defined by IFRS 10, *Consolidated Financial Statements*, or investment companies under ASC 946, *Financial Services – Investment Companies*. However, most investment companies will not be significantly impacted because interest income, dividend income, and investment gains are typically generated by transactions outside the scope of the revenue standard. However, investment entities that provide direct investment-related services may be affected.

## Application of the revenue model

The standard contains principles that an entity will apply to determine the amount and timing of revenue recognition. The underlying principle is for an entity to recognise revenue as it transfers goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. Entities will apply a five-step approach:

- Step 1: Identify the contract with the customer.
- Step 2: Identify the separate performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to separate performance obligations.
- Step 5: Recognise revenue when (or as) each performance obligation is satisfied.

### Key question 1: Who is the customer?

The new standard requires an entity to identify the contract with the customer. As part of this step, an entity must determine which party is its customer. This important step has ramifications throughout the revenue model and might significantly affect how the standard is applied. Management will need to apply judgement to determine whether the investor or the fund is the asset manager's customer based on the facts and circumstances. This is an area that may evolve as industry constituents start applying the guidance to typical investment structures.

While not determinative, certain factors in isolation may point to the fund or the investor being the customer. Management will need to weigh the different indicators, and make a conclusion based on the overall relationship.

A factor that points to the fund being the customer is a fund's ability to enter into contracts with third parties for additional services such as fund accounting or transfer agent activities. Also, there may be numerous investors that the asset manager does not deal with directly. For example, in many registered investment companies, some investors purchase shares through a third-party distributor that holds the shares in an 'omnibus account' along with other investors. An omnibus account is often used by third-party distributors to simplify the subscription and redemption process into a fund. There may be situations where the asset manager does not have visibility into the underlying investors that make up the omnibus account.

In other situations, factors may point to the investor as the customer. If the investor is heavily involved in negotiating specific fees, or interacts directly with the manager to set up the fund strategy, this could indicate that the investor is the customer. This may be the case for funds that hold very few investors and thus, the investors have the potential to play a more direct role in the activities or negotiation of the relationship. As noted above, these factors are not determinative, and management will have to consider all facts and circumstances.

Determining which entity is the customer is important when it comes to identifying the performance obligation(s), assessing the timing of revenue recognition, and capitalising contract costs. The Boards acknowledged these alternate perspectives during their public deliberations, but ultimately did not formally take a position given the wide variety of arrangements in the asset management industry. In our view, the conclusion should be based on the facts and circumstances of each arrangement and should not be viewed as an accounting policy election.

### *Key question 2: Is there a single performance obligation or multiple performance obligations?*

Another key question that impacts the timing of revenue recognition is whether there is more than one performance obligation in a contract. There are often several different fees the asset manager is entitled to, such as management fees and distribution fees. The new standard will require a manager to consider whether the services should be viewed as a single performance obligation, or whether some of these services are ‘distinct’ and should therefore be treated as separate performance obligations.

Even though services and related fees may be included in different contracts, they may represent a single performance obligation. The new standard requires an entity to combine contracts that are entered into at or near the same time and with the same customer and account for them as a single contract if (i) they are negotiated as a package, (ii) the amount of consideration to be paid in one contract depends on the price or performance of the other contract, or (iii) the services in the contracts represent a single performance obligation. Since contracts in the asset management entity are often entered into at the same time with the same counterparty, the contracts would be combined and accounted for as a single contract if, for example, the services performed under the contract represent a single performance obligation.

The new standard requires an entity to assess the services promised in a contract with a customer and identify as performance obligations those services that are distinct. A service is distinct if (i) the customer can benefit from the service either on its own or together with other resources that are readily available to the customer and (ii) the service is distinct in the context of the contract. If a service is not distinct, the entity must combine the services until such a point that a bundle of services are viewed as distinct. In some cases, this will result in all services being combined into a single performance obligation.

The customer’s perspective should be considered when assessing whether a promise gives rise to a performance obligation. Therefore, conclusions regarding who is the customer are likely to impact this determination. This is an area of significant judgement and it is possible that views will evolve in advance of the standard becoming effective.

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### **Up-front fees received by an asset manager**

Asset managers receive or pay various types of fees or costs associated with the distribution of a fund’s units. Asset managers may own a broker or distribution entity that distributes the asset managers’ sponsored products or, in some cases, the asset manager might distribute the sponsored products directly. When distribution is done by the asset manager, or through a distribution entity that is consolidated by the asset manager, the asset manager is entitled to the fees as revenue. This section does not address the accounting in the broker or distribution entity’s stand-alone financial statements.

Up-front fees are generally associated with front-end loaded distribution. Front-end loaded distribution means that an initial sales fee is paid by the investor to the distribution entity upon subscription to the fund (that is, the investor bears the fee on the front end). This fee compensates the distribution entity with the subscription amount, net of such fee, being contributed to the fund. An asset manager may also need to consider whether revenue needs to be allocated when the asset manager provides distribution services, but does not receive any direct up-front fees.

Relevant guidance under the new revenue standard, current US GAAP, and IFRS is summarised below.

New revenue standard	Current US GAAP	Current IFRS
<p>The new revenue standard requires the asset manager to assess whether the distribution service is a separate performance obligation apart from other services the asset manager is providing, or whether it is a supporting activity or component of the overall asset management services. If determined to be a <b>separate performance obligation</b>, the distribution service will generally be satisfied upon the investor's subscription and trigger immediate recognition of the revenue, assuming no further commitments remain.</p> <p>Alternatively, if the distribution and asset management services are a <b>single performance obligation</b>, the up-front fee is viewed as an advance payment for future services and is therefore recognised as revenue over time as the overall services are performed.</p> <p>An asset manager may also need to consider whether revenue needs to be allocated when the asset manager provides a distribution service that is a separate performance obligation, but does not receive any direct up-front fees.</p> <p><b>Potential impact:</b></p> <p>This analysis will be impacted by who is determined to be the customer. Up-front fees will either be deferred or recognised immediately, depending on whether or not the relationship with the customer indicates that there is a distinct service provided up-front.</p> <p>In some cases, the relationship with the customer may indicate that it is difficult to distinguish between distribution services and asset management services. Accordingly, the distribution 'service' would likely not be a separate performance obligation. It would instead be grouped with</p>	<p>Up-front fees are generally recognised as revenue upon receipt in accordance with the industry guidance in ASC 946-605, which states that, the 'fees should be recognised when received'.</p>	<p>Up-front fees might be recognised as revenue when received or deferred, depending on the facts and circumstances.</p> <p>Up-front fees are recognised as revenue when received only to the extent that services have been provided and the fees do not relate to future services. The receipt of the initial sales fee does not by itself provide evidence that all services associated with that fee have been provided or that the fair value of any up-front services is equal to the initial sales fee received.</p> <p>If the fee is linked to other services or obligations (for example, as evidenced by a fee that is not at fair value for those individual services or the pricing is only understood with reference to services to be performed in the future), the revenue that corresponds with this part of the fee is deferred and recognised as those services are performed. In these cases, the initial sales fees are typically deferred and spread over the period that the investor is expected to remain with the fund being managed.</p>

New revenue standard	Current US GAAP	Current IFRS
other activities and deferred over the period that the investor is expected to remain invested in the fund. Entities will need to consider the specific facts and circumstances of each arrangement, given the various fee arrangements and corresponding responsibilities of the distributor. These differences can have a significant impact on identifying who the customer is, as well as the nature of the performance obligations.		

*Example 1: Fees received by an asset manager (through its consolidated broker-dealer) for mutual fund share distribution services*

**Facts:** An investor pays a front-end fee to an asset manager upon investing into the fund. All of the distribution services are provided by the asset manager or one of its consolidated subsidiaries acting in a broker-dealer capacity. The service is therefore part of the asset manager's consolidated financial statements.

How should the asset manager account for the front-end fee?

**Discussion:** The accounting for the front-end fee will depend on conclusions regarding who the asset manager's customer is in this arrangement and whether there are multiple performance obligations. If the relationship between the customer and the asset manager is viewed as a single performance obligation (that is, managing an investor's money and the related activities), the distribution activity may be one of several different activities that are part of this contractual relationship with the customer. Accordingly, the manager would recognise the front-end load fee over the estimated period that the investor is expected to remain in the fund.

If the relationship with the customer is considered to include multiple performance obligations (for example, finding investors, managing assets, and entering into contracts with third parties), the distribution service may qualify as a distinct service and a separate performance obligation. The up-front fee received for the distribution service would be recognised immediately, as long as the service is complete and the manager (distributor) does not have any ongoing distribution responsibility tied to the fee.

## Up-front costs incurred by an asset manager

Asset managers may incur a cost to pay third parties for successfully introducing investors to a fund. Such costs are sometimes called sales commissions or placement fees. Often, such fees are not refundable if the investor leaves the fund. The fund usually is not required to reimburse or compensate the asset manager for the up-front cost.

New revenue standard	Current US GAAP	Current IFRS
An asset manager will recognise as an asset the incremental costs of obtaining a contract if it expects to recover those costs. The incremental costs of obtaining a contract are those costs that the asset manager would not have incurred if the contract had not been obtained (for example, a sales commission).	In accordance with industry practice, sales commissions (that is, fixed costs) paid to a third-party distributor are generally recognised as an asset and amortised over the expected period that the investor will remain in the fund, which can range from a few months to several years. The asset is reviewed for any potential impairment.	Fixed costs paid that are incremental and directly attributable to securing an investment contract (for example, sales commissions or placement fees) are capitalised if they can be identified separately, measured reliably, and it is probable that they will be recovered. An incremental cost is one that would not have been

New revenue standard	Current US GAAP	Current IFRS
<p>An asset recognised in accordance with the above is amortised on a systematic basis consistent with the pattern of transfer of the services to which the asset relates. A practical expedient is available allowing incremental costs to be expensed when incurred if the amortisation period would be one year or less.</p> <p>An impairment loss is recognised to the extent that the carrying amount of the capitalised asset exceeds the net amount of consideration to which the entity expects to be entitled in exchange for the services to which the asset relates, less the remaining costs that relate directly to providing those services.</p> <p>The asset manager will be required to consider whether such amounts are costs to obtain a contract with a customer. This may require judgement and may depend, in certain cases, on whether the fund or investor is viewed as the customer in the arrangement.</p> <p><b>Potential impact:</b></p> <p>If the costs incurred are considered to be a cost of obtaining a new contract, an asset is recognised if expected to be recovered and amortised on a systematic basis consistent with the pattern of transfer of the services to the customer. In the asset management industry, it may be more common to view these as costs to obtain a contract if the investor is viewed as the customer.</p> <p>If the cost incurred does not relate to a new contract with a customer, the cost would likely be recognised as an expense when incurred. If the asset manager views the fund as the customer, it is less likely that the fees would be viewed as a cost to obtain a new contract. This determination should be based on the facts and circumstances of the arrangement.</p>	<p>Sales commissions and placement fees are generally expensed as incurred, assuming they are not subject to the industry guidance that is currently included in ASC 946-605 (moved to ASC 946-720). Additional information regarding this retained guidance is included in more detail in the section titled, <i>'Retained US GAAP industry guidance'</i>.</p>	<p>incurred if the entity had not secured the investment management contract. The asset is amortised as the asset manager recognises the related revenue.</p> <p>If the carrying value of the capitalised asset exceeds the recoverable amount, the asset is impaired and an impairment loss is recognised.</p>



### Example 2: Placement fees

**Facts:** An asset manager is required to pay a fee to a third-party ‘marketer’ if it successfully introduces an investor into a fund that the asset manager manages. The fund is not required to reimburse or compensate the asset manager for the up-front cost. The asset manager receives a base management fee from the fund. For purposes of this example, assume the costs are outside the scope of the retained cost guidance for mutual fund distribution costs for US GAAP preparers, which is discussed in more detail in a subsequent example.

How should the asset manager account for the placement fee that it pays to the third party?

**Discussion:** The accounting for the placement fee will depend on conclusions regarding who the asset manager’s customer is in this arrangement. If the relationship with the customer indicates that the service the third party performs is **not** associated with obtaining a new contract (because the asset manager already has a management contract with the fund), the cost will likely be expensed as incurred.

On the other hand, if the relationship with the customer indicates that the placement fee is a cost to acquire a contract with a customer and such costs are expected to be recovered, the costs should be capitalised and amortised over the period benefited by the contract. The asset manager could elect to expense such costs if the amortisation period would be one year or less.

### Variable consideration, including management and performance fees

Under the new revenue standard, the ‘transaction price’ is the consideration the asset manager expects to be entitled to in exchange for satisfying its performance obligations. One of the primary performance obligations in the asset management industry is the delivery of asset management services. This performance obligation is satisfied over time as asset management services are delivered. Management must determine the amount of the transaction price at contract inception and at each reporting date. The entity will recognise revenue as the performance obligation is satisfied.

If the amount that the asset manager expects to be entitled to is variable, the variable consideration included in the transaction price is limited to the amount for which it is ‘highly probable’ (IFRS) or ‘probable’ (US GAAP) that a significant reversal of the amount of cumulative revenue recognised will not occur when the uncertainty is resolved. In making this assessment, an entity should consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, (i) the amount of consideration is highly susceptible to factors outside the entity’s influence (for example, market volatility), (ii) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, and (iii) the contract has a large number and broad range of possible consideration amounts.

Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint. Management’s estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration.

Management fees are often based on net assets under management, while performance fees are usually based on profits generated from the underlying investments held by the funds subject to certain thresholds (for example, hurdle rate, high watermark, or internal rate of return). As such, management fees and performance fees are forms of variable consideration.

The table below summarises the new guidance for management and performance fees, and compares the new standard to current IFRS and US GAAP guidance.

New revenue standard	Current US GAAP	Current IFRS
<b>Management fees:</b> A fixed percentage asset-based management fee is considered a type of variable consideration that is subject to the constraint. For	<b>Management fees:</b> A fixed percentage asset-based management fee is earned periodically for providing asset management services. These fees	<b>Management fees:</b> A fixed percentage asset-based management fee is earned periodically for providing asset management services. These fees

New revenue standard	Current US GAAP	Current IFRS
<p>management fees, an asset manager will update its estimate of the variable consideration each reporting period. Because the management fee is calculated based on net assets under management, any uncertainty related to the variable consideration will be resolved as of the end of each reporting period. The asset manager will attribute the revenue from management fees to the services provided during the period, because the fee relates specifically to the entity's efforts to transfer the services for that period.</p> <p><b>Potential impact:</b></p> <p>In general, there is no expected impact for management fees that are based on current assets under management and are not subject to clawback.</p> <p><b>Performance fees:</b></p> <p>Return-based performance fees are also considered variable consideration. The asset manager should recognise revenue only if, after an assessment of the facts and circumstances, it is highly probable (IFRS) or probable (US GAAP) that the amount of the variable consideration would not result in a significant reversal of cumulative revenue recognised when the uncertainty is resolved. This new threshold for recognising variable consideration is often referred to as the 'constraint' that must be met in order to recognise the variable consideration as revenue. Accordingly, performance fees that have a broad range of possible outcomes and are highly susceptible to market volatility will often not be included in the transaction price until the uncertainty is resolved or almost resolved. Management will need to</p>	<p>are generally recognised as revenue each period in accordance with the terms of the asset management contract.</p> <p><b>Performance fees:</b></p> <p>Performance fees based on a formula<sup>1</sup> that are tied to returns subject to performance targets (for example, high watermark) may be recognised using one of two methods.</p> <p>Under Method 1, performance fees are recognised in the periods during which the related services are performed and all the contingencies have been resolved. For hedge fund managers, this typically occurs at the end of the year or upon the occurrence of the crystallisation event. For private equity fund managers, this typically occurs upon termination of the fund or when distributions from a fund exceed the clawback portion of the historic performance fees distributions.</p> <p>Under Method 2, performance fees are recognised as revenue at the amount that would be due under the contract at any point in time as if the contract was terminated at that date (otherwise known as the 'hypothetical liquidation method'). As a result, there is a possibility that revenue recognised for fees earned by exceeding performance targets early in the measurement period could be reversed due to missing performance targets later in the measurement period.</p>	<p>are generally recognised as revenue each period in accordance with the terms of the asset management contract.</p> <p><b>Performance fees:</b></p> <p>Performance fees that are tied to returns subject to performance targets (for example, high watermark) may be recognised using one of two methods.</p> <p>Under the first approach, the asset manager recognises revenue based on the performance up to the measurement date, including an estimate of performance fees ultimately to be received. In this case, the asset manager's estimates are reassessed at each measurement date.</p> <p>Under the second approach, non-contingent and contingent fees are analysed separately. Performance fees, being contingent amounts of revenue, are recognised as the services are performed but only when the fee becomes reliably measurable, which is often at the end of the performance period, once the outcome is known.</p>

<sup>1</sup> The guidance for accounting for management fees based on a formula is included in ASC 605-20-S99-1 (formerly EITF D 96).



New revenue standard	Current US GAAP	Current IFRS
determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint. Management's estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration.		
<b>Potential impact:</b> Application of the new guidance may result in significant changes for entities that record revenue under the first approach under IFRS, or Method 2 under US GAAP, given that the new guidance requires a higher degree of certainty regarding the amount of the performance fee before revenue is recognised. On the other hand, those applying the second approach under IFRS, or Method 1 under US GAAP, will need to consider whether a minimum amount of consideration should be recognised at an earlier point in time.		

### Example 3: Management fees

**Facts:** An asset manager has a management contract with a fund to provide investment management services. The management fee is 1% of the fund's net assets and is paid quarterly with no potential for clawback.

How should the asset manager account for the management fee?

**Discussion:** We believe that, in many circumstances, revenue from periodic management fees based on assets under management will be recognised in a manner that is consistent with current practice under both IFRS and US GAAP. In this case, the asset manager will be able to record revenue each quarter because the services have been utilised by the fund. Additionally, the uncertainty is resolved as of the end of the reporting period and the fee is not subject to any potential reversal.

### Performance fees

The contractual measurement period for performance fees for hedge fund managers and traditional fund managers is often the end of the fiscal year, and in some cases even longer. Therefore, in many cases, the performance fees will be constrained until this contractual measurement period is completed. This means that the revenue will generally not be recognised in full in the interim periods (for example, at the end of each quarter). However, management will need to determine if there is a portion (a minimum amount) of the variable consideration that should be recognised prior to the end of the contractual measurement period. The full amount of the fee will likely be recognised as of the end of the contractual measurement period when the asset manager becomes entitled to an amount that is fixed. In certain cases, the full amount of the fee will be recognised upon a crystallisation event (for example, redemptions) because the amount becomes fixed at that time and is no longer subject to reversal.

Asset managers of funds with a finite life (for example, ten years) often receive performance fees that are subject to clawback on a cumulative basis, based on the performance of the fund over its life. In that case, if a fund makes a distribution to the manager, it is possible the manager will have to return the cash distribution if the fund underperforms in the future. Therefore, periodic cash receipt from a fund as a result of its current performance does not necessarily indicate that the entity is able to recognise the amount as revenue.

For funds with a finite life, asset managers will need to evaluate the appropriate time when the performance fees (or a portion thereof) are not constrained by the variable consideration guidance. This may be before the end of the fund's life. If a fund were to assess performance fees in relation to a high watermark, there may be a point in time in the later years of a fund's life cycle where the fee is no longer constrained, given the fund's cumulative performance in relation to remaining assets. For example, there could be a point in time where a fund that holds a limited number of remaining investments could sustain total losses on those investments and still exceed the high watermark. Therefore, a portion of the performance fee may no longer be constrained and should be recognised as revenue.

#### *Example 4: Performance fees*

**Facts:** An asset manager has a management contract with a fund to provide investment management services. In addition to a base management fee, the manager is entitled to a performance fee that is equal to 20% of profits generated by the investments in the fund. The management agreement states that the performance fee shall be calculated, and 'crystallised', on the last business day of the calendar year.

How should the asset manager account for the performance fee?

**Discussion:** The contractual measurement period is based on the terms of the contract, which, in this case, is as of the last business day of the year. To the extent that the performance fees are subject to the constraint on variable consideration, revenue will not be recognised in the interim periods (for example, at the end of each quarter). This determination will require judgement. Applying the guidance in the new revenue standard will often result in delayed revenue recognition as compared to current practice under the first approach under IFRS or 'Method 2' under US GAAP.

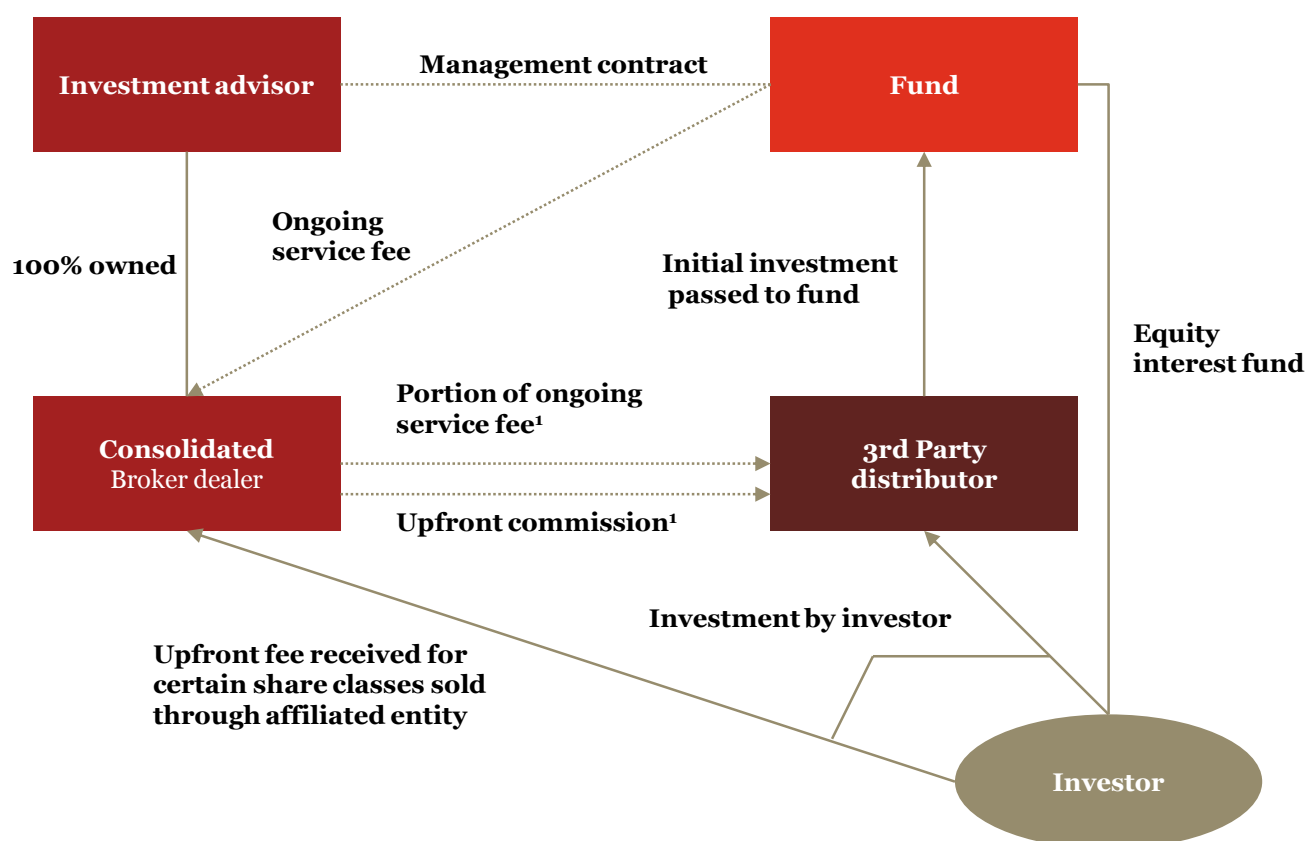
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### **Retained US GAAP industry guidance**

Under US GAAP, certain guidance on up-front costs in ASC 946-605 (now moved to ASC 946-720) has been retained. This does not apply to IFRS preparers, because this guidance did not exist in previous IFRS and the IASB did not include it in the new revenue standard.

The fee and cost arrangements can be very complex in the asset management industry, especially for registered investment companies (RICs or mutual funds) in the United States. RICs often have multiple share classes that possess unique fees, both in amount and timing. The initial introduction of the investor to the fund may either be performed by the manager (or one of its related parties) or by a separate third-party distributor, which can create additional complexities. The illustration below provides a high-level overview of basic fee arrangements to help provide context to the following guidance and example. This illustration is overly simplified, and it is important for companies to consider their own facts and circumstances. Example 5 addresses the accounting for costs paid to third parties for their services in the sales of registered mutual fund shares. This arrangement is depicted by the 'up-front commission' paid to the third-party distributor in the illustration below.

## Illustrative example



**Note:** The share class an investor chooses will impact the fee arrangement.

<sup>1</sup>Fees may not be changed if investor purchases shares from the consolidated broker dealer

The retained US GAAP guidance for up-front costs incurred is described in the table below:

New revenue standard	Current US GAAP	Current IFRS
<p><b>Up-front costs incurred for mutual fund distribution (US GAAP only):</b></p> <p>The new standard retains the narrow cost guidance included in ASC 946-605 (note that the consequential amendments move this guidance to ASC 946-720). There is no similar guidance in the IFRS standard. This guidance addresses the accounting for offering costs related to mutual fund shares. It delineates between situations where a 12b-1 fee and contingent-deferred sales charge (CDSC) is eventually received as compared to situations where there are no such deferred fees.</p> <p>The guidance is based on the logic that the residual 12b-1 fee is an ongoing benefit that the asset</p>	<p>Refer to the guidance retained under the new revenue standard.</p>	<p>No such industry guidance previously. Although similar arrangements may exist, this guidance is specific to US GAAP reporters.</p>

New revenue standard	Current US GAAP	Current IFRS
<p>manager receives for the distribution, and the CDSC serves to compensate the asset manager for the up-front distribution costs, just at a later time. Since there are fees (received at a later time) directly 'linked' to the up-front distribution activity, the guidance states that the up-front cost should be capitalised, given that it meets the definition of an asset under CON 6, <i>Elements of Financial Statements</i>.</p> <p>The opposite is true for distribution costs that are tied to a mutual fund share class that does not have a corresponding 12b-1 and CDSC fee. Since there is no <b>direct</b> residual benefit tied to the distribution cost, the asset manager is required to expense the cost as incurred.</p> <p><b>Potential impact:</b></p> <p>To the extent that an entity is able to apply the retained industry guidance, there will be no change in the accounting for up-front costs. It should be noted that the industry guidance for revenue recognition of up-front fees, which had been codified in the same section, will not be retained. This means that the accounting treatment may not change for up-front costs, but the accounting for fee revenue could be impacted.</p>		

*Example 5: Costs paid to a third party for mutual fund share distribution (US GAAP only)*

**Facts:** A mutual fund asset manager makes various types of payments for costs associated with the distribution of a fund's shares. The timing of payment varies depending on the share class. For this example, assume a mutual fund has three classes of shares: Class A, Class B, and Class C. The Class A share has a 'front-end load' as well as a 12b-1 fee. The Class B share has a CDSC, also known as a back-end load, that is used to compensate for distribution services as well as a higher 12b-1 fee relative to the Class A share. Class C has no front-end or back-end sales charge and no ongoing 12b-1 fee, but has a higher overall expense ratio. For purposes of this example, assume that the asset manager has hired the services of a third-party distributor to sell the fund's shares.

How should the asset manager account for the fee paid to the third-party distributor?

**Discussion:** The accounting treatment for costs associated with mutual fund shares falls outside the cost guidance in the new standard, given that the FASB decided to retain the industry guidance in ASC 946-605-25 (moved to ASC 946-720). As a result, this guidance provides two accounting treatments based on whether the asset manager is 'reimbursed' for distribution-related costs through either a 12b-1 fee or CDSC.

This guidance states that, if the asset manager is not reimbursed through a back-end load and 12b-1 fee, the distribution costs are more akin to ‘start-up costs’ and should be accounted for in accordance with ASC 720-15, Start-Up Costs, which typically results in immediate expense recognition.

For Class A, the asset manager is compensated immediately for distribution costs by collecting a front-end fee from the fund. The asset manager then makes a separate payment to the third-party distributor to compensate it for selling the Class A shares. Given that Class A has a front-end load instead of a CDSC, the asset manager will recognise an expense for the distribution services up-front in accordance with the retained guidance.

For Class B, the asset manager receives both a CDSC and 12b-1 fee, but no up-front fee, despite having to compensate the third-party distributor upon the completion of its distribution service. Based on the retained guidance in ASC 946-605 (moved to ASC 946-720), there are expected future benefits directly linked to the distribution services in the form of the CDSC and 12b-1 fee that the asset manager will recoup at a later time. Therefore, to the extent that the asset manager pays a third-party distributor to sell the Class B shares, the asset manager should capitalise the cost as described in the retained guidance. Based on the current wording in the standard, the incremental direct costs should be amortised, and the indirect costs should be expensed as incurred (if applicable) as described in the retained cost guidance in ASC 946-720.

Class C does not have either a back-end load or 12b-1 fee. Therefore, any costs that are paid by the asset manager to a third party for the distribution services will typically be expensed in the period incurred.

It is important to emphasise that there may be similar economic and commercial reasons for up-front payments in funds other than mutual funds. However, based on the language in the standard, it would appear inappropriate to analogise this guidance to other funds that have similar economic arrangements, but are not mutual funds. Consequently, this could result in different treatment for funds with up-front costs if one is a registered mutual fund and the other is not. The general contract acquisition cost guidance in the new revenue standard will be applied to funds that are not mutual funds and may result in different accounting treatment than otherwise provided in the retained guidance described above. This will likely be an area of continued debate during the pre-implementation phase as constituents assess the practical implications of the retained guidance.

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## Other considerations

This asset management industry supplement discusses the areas in which the new revenue standard is expected to have the greatest impact. Other considerations include the following:

### *Employee compensation*

Some asset managers provide compensation awards to their key employees whereby these employees receive a specified percentage of the performance fees earned by the asset manager. The compensation expense resulting from such arrangements is measured and accrued under the applicable guidance in IFRS and US GAAP. At each reporting date, asset managers that currently apply the first approach under IFRS or Method 2 under US GAAP are therefore able to match the timing of recognition of compensation expense with the associated performance fee income. Under the new standard, however, the timing of revenue recognition and compensation expense may not align, as the guidance governing compensation expense is not changing.

### *Systems and processes*

The final revenue standard is effective for the first quarter of 2017 for calendar year-end public entities. Therefore, asset managers that elect the full retrospective transition method should assess process and systems implications as early as possible to capture the information needed for retrospective application. This might be particularly important for those asset managers that currently recognise performance fees using the first approach under IFRS or Method 2 under US GAAP, as described above.

### *Investor relations*

Asset managers that recognise performance fees in accordance with the first approach under IFRS or Method 2 under US GAAP may experience significant changes to how they report their results of operations. These changes will need to be communicated to the investor community. Asset managers might also want to consider any new non-GAAP metrics needed to assist the investor community in understanding their operating results.

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## About PwC's Asset Management practice

The asset management industry faces challenging markets, new regulatory reform measures, and competition for clients and talent – All against a backdrop of heightened expectations from investors, regulators, industry partners, and other stakeholders. Our Asset Management partners and staff can assist in meeting these key industry challenges.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 184,000 people who are committed to delivering quality in assurance, tax, and advisory services.

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## Questions?

PwC clients who have questions about this In depth should contact their engagement partner. Engagement teams that have questions should contact members of the Revenue team in Accounting Consulting Services

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