

# The Blackstone Group

October 22, 2010

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: Proposed Accounting Standards Update to Topic 605, “Revenues from Contracts with Customers” (File Reference No.: 1820-100)**

The Blackstone Group is pleased to comment on the proposed Accounting Standards Update on Revenue Recognition (Topic 605), *Revenues from Contracts with Customers* (the “proposed ASU”).

Blackstone is a leading asset manager that specializes in managing alternative asset classes such as private equity funds, real estate funds, fund of hedge funds, and credit-oriented funds with approximately \$111 billion of assets under management<sup>(1)</sup>. Our key sources of income, arising from contracts with customers, comprise management and advisory fees, and transaction and other fees, including monitoring fees received directly from portfolio companies. Base management fees are earned from the limited partners of each of our managed funds as a fixed percentage of assets under management, net asset value, total assets, committed capital or invested capital, based on contractual terms specified in the underlying investment advisory agreements. In addition, Blackstone, like other managers of alternative assets, earns performance fees on the underlying performance of hedge funds (“incentive fees”) and is also allocated a percentage of appreciation in its private equity type funds (“carried interest”), collectively referred to as “performance-based fees”.

## Scope

We note that the proposed ASU applies to all contracts with customers except for contractual rights and obligations within the scope of certain topics, including Topics 320 on debt and equity securities and Topic 825 on financial instruments (amongst others). We acknowledge that components of Blackstone’s income generating transactions are included within the scope of the proposed ASU such as base management fee arrangements with limited partners, transaction and advisory arrangements and monitoring and other fee generating arrangements. However, certain components fall within the scope exception including investments in debt and equity instruments that fall within the scope of Topic 320.

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(1) As of June 30, 2010.

Blackstone, like most other managers of alternative assets, makes principal investments in certain of its managed funds (a General Partner, or “GP” interest) on which we are entitled to receive a proportionate share of underlying fund appreciation alongside the limited partners. This investment is accounted for using the equity method of accounting. As well as receiving allocations of income, this GP interest also attracts a disproportionate allocation of profits, whereby up to 20% of the overall appreciation allocated to limited partners is reallocated to the GP, subject to the achievement of certain performance hurdles. Carried interest is calculated during interim periods based on cumulative fund performance to date, which in turn is based on the fair value of a fund’s underlying investments and realized values of disposed assets. As a result, carried interest is itself reflective of its fair value in interim reporting periods. Such amounts form part of Blackstone’s overall investment in that fund and are recorded within investments in the consolidated statement of financial condition. When allocations are realized, the amounts are distributed as cash and the investment balance is reduced accordingly. As the carried interest represents an equity investment in an underlying fund, we believe that it is a financial instrument which is outside the scope of the proposed ASU. We would appreciate confirmation from the FASB that this is the intended interpretation of the proposed ASU. In the event that the Board has an alternate view that performance fee allocations are not separate equity instruments and do in fact fall within the scope of the proposed ASU, we offer the following comments. Our comments are focused on the recognition of revenue relating to the provision of services in contracts with customers only.

### **Recognition of Revenue**

Question 1: *Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether to:*

- a) Combine two or more contracts and account for them as a single contract*
- b) Segment a single contract and account for it as two or more contracts; and*
- c) Account for a contract modification as a separate contract or as part of the original contract.*

*Do you agree with that principle? If not, what principle would you recommend and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?*

We agree with the principle of price interdependence as a basis for determining when to combine two or more contracts with customers and further agree that an entity should segment a single contract into its component parts if pricing of some good or service is independent of pricing of other goods and services in the contract. The factors set out in paragraph 15 are sufficiently clear to determine when such contract should be segmented. However, we believe that separate performance obligations should also be considered in determining whether a contract should be segmented.

In the asset management industry, it is common to enter into investment management agreements with limited partners in which the manager earns both a base management fee and a performance-based fee. While the fee structures are contained within the same contract with a customer, they can be bifurcated and are at times separable. In certain instances, an asset manager may agree to only receiving a management fee or only a performance-based fee, providing evidence that such services may regularly be sold separately. We believe that, in addition to price interdependence, it is necessary to evaluate separate and identifiable performance obligations that would also result in a segmentation of a contract. For example, a base management fee is a fee that is paid in exchange for the provision of managing third party capital. Irrespective of whether the capital is invested or if the investment strategy is successful such that it results in positive returns to third party investors, a manager would receive this base management fee. In contrast, a separate performance obligation exists in delivering positive returns to investors and in return, separate performance-based fees are payable to the manager.

Both price interdependence and separate performance obligations contained within a single contract should be considered in the determination of whether a contract should be segmented.

*Question 2: The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?*

As noted above, we believe that separate performance obligations should be accounted for separately and should be considered in determining whether a single contract with a customer should be segmented on such basis.

The factors set out in paragraph 23 assist in identifying whether a bundle of goods or services is distinct. The nature of various service contracts entered into by an entity would assist in determining whether the entity sells an identical service separately or if the entity could sell the service separately because the service has a) a distinct function and b) a distinct profit margin. In certain instances, an asset manager may enter into a contract with an investor to manage a pool of capital in exchange for a base management fee. In other instances, the investor may be seeking high returns and is willing to pay a percentage of performance to the manager in exchange for the delivery of high returns. Such contracts provide evidence that an entity does sell identical services separately rather than as part of a bundled arrangement within an investment management agreement.

Irrespective of whether or not an entity has entered into such contracts, the possibility exists because the delivery of returns is distinct from passively managing a pool of assets and a distinct profit margin exists for such a service.

*Question 3: Do you think that the proposed guidance in paragraphs 25-31 and related implementation guidance are sufficient for determining when control of a promised good*

*or service has been transferred to a customer? If not, why? What additional guidance would you propose?*

The proposed guidance set out in paragraphs 25-31 is more relevant to the provision of goods rather than the provision of services, primarily because it focuses on the transfer of control in determining whether a performance obligation has been fulfilled. Paragraph 30 provides some guidance on when control would be considered transferred; however, none of these are relevant to the delivery of services.

For example, in the asset management industry, there is a continuous transfer of services over the life of an investment management agreement. The first service, as discussed above, is to passively manage a pool of capital in exchange for a fee that is calculated as a small percentage (1-2%) of committed capital, invested capital, net asset value (“NAV”), assets under management (“AUM”), total assets or some other variable. Such fee is paid in interim periods (monthly, quarterly, semi-annually or annually) over the life of the contract. Once the fee is paid, it is non-refundable and relates to the provision of this basic service over that interim period. We respectfully request that the FASB clarify that a base management fee may be recognized in interim reporting periods as the obligation to pay criteria is fulfilled. While the base management fee contains a performance element and therefore has some variability (e.g. certain metrics such as NAV or AUM will change between periods as a result of not only contributions and distributions but also interim fund performance), it is payable in interim periods and is not subject to any kind of clawback based on future performance. As a result, we request that the FASB clarify that in such a scenario, that the performance obligations have been met and it is appropriate to recognize revenue in such interim periods. This recognition basis reflects the economics of a base management fee rather than estimating a total transaction price and allocating on a straight line basis over the life of a management contract on the basis of passage of time.

In addition, in exchange for the delivery of returns to an investor, the investment manager will receive a portion of that performance as a performance-based fee. Such fee may realize in a measurement period, at which point an investor becomes unconditionally obligated to pay such fee. In other instances, the performance-based fee would only be realized if underlying investments are disposed of at a gain. As a result, there is not an unconditional obligation to pay until underlying investments are disposed of. As performance-based fees are calculated based on cumulative fund performance, any fees realized in interim periods are subject to clawback. It is only at the end of a fund’s life that the obligation is satisfied. Application of the guidance contained in the proposed ASU would result in revenue being recognized only when the full amount has been determined and there is an obligation to pay. No amount of revenue would be recognized in any interim period. This does not reflect the economics of a performance-based fee nor does this reconcile with fair value concepts in ASC 820, *Fair Value Measurements and Disclosures* (“ASC 820”).

Under current GAAP, an asset manager is permitted to recognize revenue in interim periods based on the amount that would be received if a management contract was

terminated as of that date. Performance fees recorded in interim periods are subject to positive or negative adjustments in subsequent periods based on fund performance. The principle of recognition results in the recognition of revenue in interim periods based on liquidation scenarios, specifically an **exit price** concept similar to that contained in ASC 820. This methodology for recognizing revenue in interim reporting periods results in substantially the same accounting results as holding an equity interest as described in the scope section above. The current methodology for recognizing revenue relating to performance-based fees is discussed further in our response to Question 4.

### **Measurement of Revenue**

*Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 36 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.*

*Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?*

The Proposed ASU indicates that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 discusses criteria that assist in the determination of whether the transaction price is reasonably estimable, specifically a transaction price is reasonably estimable if both of the following criteria are met:

- a) The entity has experience with similar types of contracts; and
- b) The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances

Paragraph 39 discusses the scenarios which reduce the relevance of an entity's experience and include the following:

- a) The consideration amount is highly susceptible to external factors (e.g. volatility in the market, judgment of third parties, risk of obsolescence of the promised good or services)
- b) The uncertainty about the amount of consideration is not expected to be resolved for a long time
- c) The entity's experience with similar types of contracts is limited; and
- d) The contract has a large number of possible consideration amounts

With respect to base management fees, an asset manager has experience with similar types of contract and the entity's experience is relevant to the contract because typically significant changes are not expected. Base management fees represent stable revenue sources. While the basis on which management fees are calculated are based on variable

metrics that are susceptible to external factors, the segmenting of a management contract into interim performance periods would allow recognition of such management fees in interim periods based on the amounts that an investor is obligated to pay over that interim performance period. Management fees are paid in interim periods, relate to a period for which service obligations have been satisfied and are not subject to any form of refund. As a result, we do not believe that management fees are variable and therefore should be recognized in interim reporting periods as the appropriate basis multiplied by the fee percentage pro-rated for the applicable measurement period.

With respect to performance-based fees, we believe that revenue should be recognized based on an estimated transaction price. However, we disagree with the criteria set out in paragraph 38 as the basis for determining if a transaction price is estimable.

For an asset manager, performance-based fees in the form of carried interest are typically based only on fund performance and the GP is entitled to an allocation of a proportion of that performance. At the end of each reporting period, the GP will calculate the amount of performance-based fees that would be due based on cumulative performance. As performance of underlying funds varies period to period, it is necessary to make positive or negative adjustments to the amount of carried interest allocated to the GP to reflect the amounts that would be due to the GP based on cumulative performance up to that particular point in time. It is common for asset managers that hold carried interests or performance fees to enter into compensation arrangements with employees (carry plans), where performance-based fees/carried interest allocations are shared between the GP and employees. Such arrangements result in the recognition of compensation expense in interim periods to match the related performance-based fee/carried interest allocation

Carried interest is calculated based on cumulative inception to date performance and is currently recognized in interim periods as permitted under Method 2 of ASC 605-20-S99. Under this guidance, an entity is permitted to recognize revenue relating to performance-based fees that are not finalized until the end of a period of time specified in the contract, on an interim basis, based on the amount of revenue that would be due if the contract was terminated at the end of a reporting period (Method 2). The amount that would be due in any given reporting period is based on underlying fund performance. As funds carry their investments at fair value as required by the AICPA Accounting and Auditing Guide, *Investment Companies*, any changes in value of the underlying fund performance would be reflected in the level of performance-based fees recognized in that period. As noted above, a corresponding compensation expense entry is recorded to reflect the amount that would be owed to employees participating in carry plans as if the fund was terminated at the end of that reporting period. This results in an appropriate matching of revenues and related expenses.

Investment Companies apply the fair value provisions set out in ASC 820, including the use of estimates and determination of fair value when a market is not active. There is extensive review of valuation procedures and by extension, an extensive review of the amount of performance-based fees that are recognized in any given period based on underlying fund performance. If the use of judgment and management estimates is

permitted in ASC 820 in determining fair value, we believe that judgment should also be permitted in the estimation of performance-related fees. Estimating the transaction price and recognizing revenue on a straight line basis using the passage of time methodology would be a less relevant measure of what performance-based fees would be generated by the asset manager at any given point in time.

We believe that a more relevant method of recognizing performance-based fees should be based on the fair value of underlying investments at that point in time as that is the methodology that most accurately reflects the economics of performance-related fees. If a contract was terminated at a point in time and all of the positions liquidated at their then fair values (which is reflective of an **exit price**), that would be the basis for calculating the amount of performance-based fees that would be paid to the GP.

The example set out in the proposed ASU leads to the conclusion that performance-based fees are variable and that it is not possible to estimate such fees over the life of a fund. This would result in a deferral of revenue for an extended period of time and recognition in a tail period at the end of each fund's life. If this is the intent of the FASB, then we would appreciate further guidance on the recognition of related compensation expense and whether this should also be deferred in order to match the revenue recognition principles.

We believe that the method of recognition proposed does not provide meaningful information to users of financial statements. Typically, analysts of the asset management industry base their projections assuming Method 2 revenue recognition principles. In certain instances, where revenue is recognized based on Method 1 (under which revenue is recognized when all related contingencies are resolved), preparers provide non-GAAP based information to provide analysts with revenues as if they were calculated under Method 2 allowing comparability between asset managers.

In order to provide the most meaningful financial information to users of financial statements, recognition of performance-based fees in the asset management industry should be permitted in interim periods based on cumulative underlying fund performance to date as currently permitted under Method 2 of ASC 605-20-S99.

*Question 5: Paragraph 43 proposes that the transaction price should reflect a customer's credit risk if its effect on the transaction price can be reasonably estimated. Do you agree that a customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why not?*

No comment.

*Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why not?*

No comment.

*Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If no, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?*

As noted in the responses to Questions 1 and 2, we believe that a separate performance obligation within a contract, together with a separate transaction price, should result in bifurcation of that contract into constituent parts with revenue recognized on the basis of the fulfillment of each separate obligation rather than an allocation of the transaction price to separate performance obligations in a contract in proportion to the standalone selling price.

### **Contract Costs**

*Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, Intangible Assets), an entity should recognize an asset only if those costs meet specified criteria.*

*Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?*

We note in our response to Question 2 that one of the costs incurred in the provision of asset management services is compensation to employees. Part of the cost of managing assets is recovered through the receipt of management fees; however, another component of compensation is tied directly to variable performance-based fees. As these fees are not considered estimable under the proposed ASU, the related costs may not also be considered estimable. While these costs are directly attributable to the obligations under the investment management contract, they are calculated in the same way as performance-based fees. As a result, the costs, while meeting the recognition criteria, may not be recognized because they cannot be reasonably estimated. We expand on the implications of this in our response to Question 9.

*Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation.*

As discussed in the response to Question 4 and 8 above, it is unclear whether an entity could defer expenses related directly to performance-based variable fees. Assuming that expenses cannot be deferred, it may be determined that a reporting entity has entered into an onerous performance contract for which an additional liability must be recognized.



Assuming that the same guidance relating to estimates of variable fees is applied in determining whether an entity has entered into an onerous performance obligation, then inevitably, a liability would have to be recognized. It is assumed that revenues are zero as they cannot be reasonably estimated; however, costs to perform the obligations of the contract would need to be recognized at inception. We do not believe that this is the intention of the FASB. We request that the FASB clarifies that the measure of an onerous performance obligation should include expected performance-based fees that may not be recognizable under the variable revenue criteria.

*Do you agree with the costs specified? If not, what costs would you include or exclude and why?*

Generally, we agree with the costs specified as they relate directly to the revenue generating contract with a customer.

### **Disclosure**

*Question 10: The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?*

We do not agree that the enhanced disclosure requirements would provide users of financial statements with sufficient information on amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. As previously discussed, the current GAAP guidance allows for revenue recognition in interim periods based on the fair values of underlying investments. This provides users of the financial statements with sufficient financial information to forecast future earnings potential.

The industry specific guidance that is currently in place under US GAAP has been developed over a number of years in response to the many different issues related to revenue recognition that are faced by different industries. We believe that sweeping principles-based changes applied on a retrospective basis will result in less meaningful revenue recognition principles that do not reflect the economics of a particular contract. We believe that the disclosure requirements set out in the proposed ASU do not bridge this gap.

The proposed disclosures are both onerous and will require significant resources to implement. Further, they do not provide meaningful information to users and are likely to lead to a further proliferation of non-GAAP measures to aid users of financial statements in understanding the fundamental economics of a business. This may reduce comparability of competitor financial data and will further erode the relevance of GAAP based financial information.

*Question 11: The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.*

*Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?*

As previously discussed, we do not agree with the proposed revenue recognition guidance because it does not accurately reflect an entity's position at a given point in time. In the asset management industry, revenue relating to performance-based fees is dependent on the application of fair value accounting guidance. At any given point, a user of the financial statements is able to determine the amount of revenues earned if an entity was liquidated at that particular point in time. The fair value concept is extended to the recognition of performance-based fees in that they are based on an exit price at such time. We believe that this provides more meaningful information to users of financial statements than the guidance in the proposed ASU.

*Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?*

Disaggregation on this basis may lead to different interpretation by different preparers of financial statements as it is judgment based.

### **Effective date and transition**

*Question 13: Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why?*

*Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better?*

We do not agree that an entity should apply the revised revenue recognition guidelines on a retrospective basis. The revenue recognition guidance contained in the proposed ASU requires the application of significant judgment and estimation which is difficult to apply when you have the benefit of hindsight. Further, from an operational perspective, this would require an immense commitment of resources in terms of time and manpower for limited benefit. As noted above, we do not agree with the revenue recognition conclusions that would be reached if the guidance was applied as proposed and further believe that preparers would need to provide non-GAAP measures to supplement GAAP numbers that provide no meaningful information to users of financial statements.

Should the FASB decide to issue the revenue recognition guidance as contained in the proposed ASU, we request that the guidance should be applied on a prospective basis for

new contracts entered into with customers. Existing contracts should be subject to grandfathering provisions permitting revenue to be recognized under existing GAAP guidance.

### **Conclusion**

In summary, Blackstone appreciates the efforts by the FASB and IASB to create a set of converged accounting standards that would result in meaningful, relevant and transparent financial statements and disclosures; however, we believe that the requirements contained in the proposed ASU would result in less meaningful financial statements with potentially long periods in which no revenues are recognized as a result of such revenues not being estimable. We have spent considerable time and effort in educating the user community on how revenues are generated and recognized and believe that our current methodology results in the matching of revenues and related expenses and is based on an exit price notion that is consistent with fair value. Application of the guidance contained in the proposed ASU on a retrospective basis would be expensive and would require the provision of non-GAAP measures in order to assist the user community in evaluating the earnings potential of The Blackstone Group. If the FASB does not agree with our assessment that performance fees and allocations represent an equity interest carried at fair value as described in the scope section above, we respectfully request that the FASB take into consideration the concerns we have raised in the remainder of this letter.

The Blackstone Group appreciates the opportunity to comment on the proposed ASU. If you have any questions concerning our comments, please do not hesitate to contact Kathleen Skero at 212 583 5605.

Yours truly,



Kathleen Skero  
Principal Accounting Officer