FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	Transition Resource Group for Revenue Recognition
Paper topic	Scoping Considerations for Incentive-based Capital Allocations, Such as Carried Interest

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Purpose

1. Some stakeholders from the asset management industry informed the staff that there are questions about the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (Update 2014-09), about the scope of the new revenue standard for incentive-based capital allocation arrangements, such as carried interest arrangements.

Background

2. Investment companies (also known as funds) frequently utilize a partnership structure in which limited partners (LPs) provide capital to the fund. Commonly, the asset manager of the fund, or its affiliate, is the general partner (GP) in the partnership and owns an initial (for example, 1 percent) investment in the fund. That initial investment might be accounted for under the equity method of accounting or other generally accepted accounting principles (GAAP). Over the course of the fund's life, the asset manager performs various services, which include identifying and managing the investments and, in some cases, the asset

manager of a private equity fund will replace an investee's management partially or entirely with its own management team in efforts to improve performance.

3. Asset managers, particularly those that manage private equity or real estate funds, are commonly paid through two different types of fees: (a) a management fee (usually a fixed percentage of total capital under management) and (b) an incentive-based fee (based on the extent to which the fund's investment performance exceeds a contractually predetermined benchmark). There are many variations in practice, and some incentive-based fees are calculated and allocated to the GP on an investment-by-investment basis, while others are based on cumulative fund performance. The allocation (distribution) of profits is directed by the terms of the partnership agreement and commonly is referred to as a waterfall. Frequently, the contractual arrangements contain restrictions on the partners' ability to redeem their investment as well as termination provisions that provide the asset manager with a contractual right to fees earned through the termination date, pursuant to distribution provisions in the agreement. Refer to TRG Agenda Ref No. 10 for additional discussion on evaluating termination provisions.

4. For funds that are non-U.S. corporations, the asset manager might receive incentive-based fees in the form of cash. However, for private equity or real estate funds that are limited partnerships, the asset manager generally receives incentive-based fees via an allocation of capital from the fund's LPs. Such incentive-based capital allocations (commonly referred to as carried interests) generally are subject to reversals or clawbacks in future periods if the fund performance does not continue to exceed the contractually predetermined benchmark.

5. Many stakeholders in the asset management industry think there are two aspects to those incentive-based fee arrangements: (a) compensation for asset management services and (b) financial exposure to the fund's performance.

6. The Emerging Issues Task Force (EITF) Topic No. D-96, "Accounting for Management Fees Based on a Formula," which was later codified in paragraph 605-20-S99-1, provides guidance on accounting for incentive-based performance fees, including carried interests. That guidance includes two methods that the U.S. Securities and Exchange Commission (SEC) staff considers acceptable revenue

recognition methods. Under Method 1, incentive fees are recognized if the services are performed and all contingencies have been resolved. Method 1 generally results in revenue not being recognized for incentive fees until the end of a specified measurement period (which sometimes is the end of the contract). Under Method 2, incentive fees are recognized throughout the contract and are measured on the basis of the amount that would be due from the customer (calculated using a prescribed formula), assuming the contract was terminated at the reporting date (that is, liquidation value). The SEC staff at the time stated that it would not object to Method 1 or Method 2 for contracts that had termination provisions in the arrangement. Currently, there is diversity in practice—some asset managers recognize revenue under Method 1, while others recognize revenue under Method 2. When the carried interest is earned under Method 1 or Method 2 by the asset manager or GP, revenue is recognized and the corresponding debit is recorded to investments, carried interest receivables, or some other asset. In subsequent periods, under Method 2, carried interest amounts allocated to the GP are reversed if fund returns do not exceed contractually predetermined benchmark targets.

7. To illustrate the two methods, consider the following example:

> An asset manager enters into a contract with a customer to provide investment management services over the life of the investment fund, which is expected to be 10 years. The asset manager is paid a fee equal to 2 percent per year of assets managed plus a performance-based incentive fee equal to 20 percent of the fund's return in excess of the return of the S&P 500 over the fund life. The contract can be terminated by either party with reasonable notice at the end of each quarter and the asset manager has the right to receive the fees earned through the date of termination, pursuant to the distribution provisions in the contract. The fund's return exceeds or is below the return of the S&P 500 by the following amount for each year:
>
> - $100,000 in Year 1
> - $50,000 in Year 2
> - $10,000 in Year 3

- ($50,000) in Year 4
- $20,000 in Year 5
- $20,000 in Year 6
- $20,000 in Year 7
- ($70,000) in Year 8
- $80,000 in Year 9
- ($40,000) in Year 10.

Thus, the total return of the fund for the 10-year period exceeds the S&P 500 return by $140,000.

8. If the asset manager applies Method 1 to the facts in the above example, the asset manager would be precluded from recognizing revenue from the performance-based fee at the end of the first nine years because, at those times, all contingencies have not been resolved (that is, the performance-based fee ultimately will be determined on the basis of the fund's return in excess of the return on the S&P 500 for the 10-year period). Therefore, by applying Method 1, the asset manager would recognize $28,000 from its performance-based fee ($140,000 × 20%) only at the end of the 10-year period (that is, when all the contingencies related to the performance-based incentive fee are resolved).

9. Alternatively, if the asset manager applies Method 2 to the facts in the above example, the asset manager would recognize or reverse the following amounts of performance-based incentive fee revenue at the end of each year (for the purpose of this example, interim quarterly reporting is not considered):

Year 1 = $20,000 ($100,000 × 20%)
Year 2 = $10,000 ($50,000 × 20%)
Year 3 = $2,000 ($10,000 × 20%)
Year 4 = ($10,000) ($50,000 loss × 20%)
Year 5 = $4,000 ($20,000 × 20%)
Year 6 = $4,000 ($20,000 × 20%)
Year 7 = $4,000 ($20,000 × 20%)
Year 8 = ($14,000) ($70,000 loss × 20%)
Year 9 = $16,000 ($80,000 × 20%)

Year 10 = ($8,000) ($40,000 loss × 20%)

Total revenue for 10-year period: $28,000.

10. The staff understands that the majority of nonalternative asset managers (that is, those managing mutual funds that are subject to the Investment Company Act of 1940) in the United States recognize revenue in accordance with Method 1. In addition, some alternative asset managers (that is, those managing private equity or real estate funds that are exempt from the Investment Company Act of 1940) in the United States apply Method 1 and some apply Method 2.

11. On various occasions during development of the new revenue standard, the FASB and the IASB discussed how the new revenue recognition guidance would apply to asset management contracts. The topic was discussed during public joint Board meetings on September 24, 2012, November 19, 2012, and January 30, 2013. At the January 30, 2013 joint Board meeting, the Boards confirmed their proposal in the 2011 Exposure Draft that an asset manager's performance-based incentive fees are subject to the constraint on variable consideration.

12. Example 25 of Update 2014-09 (see Appendix A) illustrates the application of the constraint guidance to an asset management contract; however, it does not mention whether the example applies to equity-based arrangements in which the asset manager is compensated for performance-based fees via an equity interest (that is, incentive-based capital allocations such as carried interest).

13. The TRG received a submission asking whether or not incentive-based capital allocations, such as carried interest, are within the scope of Topic 606. Because carried interest reflects the GP's exposure to the fund's performance and, therefore, contains characteristics of a financial instrument, some stakeholders questioned whether other GAAP might apply, rather than Topic 606.

14. There are three primary aspects of the overall arrangement between the asset manager (GP) and the fund in the situation described within this paper: (a) the initial equity invested by the GP (for example, 1 percent), which receives a pro-rata allocation of the fund's revenues, expenses, gains, or losses, (b) a management fee typically based on a fixed percentage of assets managed (for example, 2 percent), and (c) carried interest (for example, 20 percent of the fund's return in excess of the

return of a specific benchmark). The implementation question submitted by some stakeholders from the asset management industry is about incentive-based capital allocations, such as carried interest. Unless otherwise specifically noted, the analysis in this paper is not intended to describe the accounting for (a) the initial equity interest that might be held by the GP or (b) the management fee that typically is charged to the fund and payable in cash.

Accounting Guidance

606-10-15-2 An entity shall apply the guidance in this Topic to all **contracts** with **customers**, except the following:

a. Lease contracts within the scope of Topic 840, Leases.
b. Insurance contracts within the scope of Topic 944, Financial Services—Insurance.
c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:
   1. Topic 310, Receivables
   2. Topic 320, Investments—Debt and Equity Securities
   3. Topic 323, Investments—Equity Method and Joint Ventures
   4. Topic 325, Investments—Other
   5. Topic 405, Liabilities
   6. Topic 470, Debt
   7. Topic 815, Derivatives and Hedging
   8. Topic 825, Financial Instruments
   9. Topic 860, Transfers and Servicing.
d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.
e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Topic would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis. Topic 845 on nonmonetary transactions may apply to nonmonetary exchanges that are not within the scope of this Topic.

15. See Appendix A for Example 25 (Management Fees Subject to the Constraint) in Topic 606.

Summary of Outreach

16. The staff performed outreach on the scope question in this paper with a broad group of asset managers, ranging from traditional asset managers for whom carried interest is a relatively small part of the overall business, to alternative asset

managers for whom revenue include significant amounts of carried interest related to long-term private equity or real estate investment strategies. On January 7, 2016, stakeholders in the asset management industry participated in a workshop held by the staff to discuss the scope question for asset managers. Fourteen preparers attended the workshop (seven preparers that apply Method 1 and seven that apply Method 2), as well as four public accounting firms.

17. While the focus of the staff's outreach and the workshop was on scope, preparers that apply Method 2 generally expressed views that the economics of carried interest arrangements would not be faithfully represented under Topic 606, especially for long-term arrangements, because revenue recognition would be deferred significantly longer than current practice. In contrast, preparers that apply Method 1 generally expressed views that the accounting model under Topic 606 is sufficient. Those views of preparers that apply Method 1 and Method 2 were consistent with previous feedback provided to the Board during development of the new revenue standard.

Implementation question: Are incentive-based capital allocations, such as carried interest, within the scope of Topic 606?

18. The staff is aware of the following three different stakeholder views: (a) incentive-based capital allocations are within the scope of Topic 606, (b) incentive-based capital allocations are outside of the scope of Topic 606 because they are ownership interests and should be accounted for under other GAAP, and (c) an entity should account for carried interest either as a revenue arrangement under Topic 606 or as an ownership interest in accordance with other GAAP on the basis of the nature and substance of the arrangement.

19. Stakeholders asserted to the staff that there would be a material difference between applying Topic 606 and other GAAP to these arrangements.

View A—Incentive-Based Capital Allocations Are in the Scope of Topic 606

20. Stakeholders who support View A assert that the limited partnership agreement that governs the arrangement is a contract with a customer, because the allocations described in the partnership agreement are designed to compensate the asset manager for its services in managing the fund. In addition, these stakeholders observe that incentive-based capital allocations do not differ in substance from the

compensatory nature of other incentive-based performance arrangements for which the asset manager receives cash. View A supporters assert that in most cases, the initial equity interest held by the asset manager and the related pro-rata allocation of gains and losses to which the GP normally would be entitled (for example, 1 percent of the gains and losses for a 1 percent investment in the fund) is not commensurate with the potential returns on the investment that the asset manager can earn via carried interest (which could be a much larger percentage). Accordingly, the carried interest represents compensation for the asset manager's service of managing the fund. In other words, without the management services performed by the asset manager for the fund, it is unlikely that the LPs would agree to allocate significant excess returns to the capital account of the GP. If the GP does receive returns via the carried interest, the returns are much higher (for example, 20 percent of returns above a contractually predetermined benchmark) than what a similar equity interest would receive via its normal pro-rata allocation (for example, 1 percent). Stakeholders with this view believe that the direct connection between the amount of carried interest allocated to the GPs account and the asset manager's services is evidence of a service arrangement and not solely a return from an ownership interest. While there are circumstances in which different classes of shareholders receive different returns (for example, one class of stock could receive a dividend and another class of stock could receive no dividend), in this case, the excess return payable to the GP is based on the GP's performance. Supporters of View A think the incentive-based capital allocations are similar to performance bonuses in contracts with customers in other industries (for example, a bonus payable to a consulting firm that redesigns a customer's payroll processes if a specific metric is met, and if the metric is met, the amount of the bonus is 20% of the customer's reduced operating costs for a period of time).

21. Under View A, carried interest would be included in the transaction price if it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur in accordance with the constraint guidance on variable consideration. Paragraph 606-10-32-12 includes guidance for assessing whether an estimate of variable consideration is constrained. Some of the factors outlined include whether the consideration is highly susceptible to factors outside the entity's influence, the

length of time before the uncertainty is resolved, and the entity's experience with similar types of contracts.

22. Also under View A, an entity would need to apply the disclosure requirements for Topic 606 that would provide financial statement users with information about its contracts with customers. Under Topic 606, an entity is required to disclose information about its performance obligations, including a description of when an entity typically satisfies its performance obligations, the significant payment terms, and whether the consideration is variable and is typically constrained. Disclosures should explain the judgments, methods, inputs, and assumptions used in determining the transaction price and assessing whether an estimate of variable consideration is constrained. An entity is required to disclose revenue recognized in the reporting period from performance obligations satisfied or partially satisfied in previous periods (for example, due to changes in estimates of variable consideration). An entity also is required to disclose the aggregate amount of the transaction price allocated to remaining performance obligations (after considering the constraint) and whether there is variable consideration that is not included in this disclosure because it is constrained.

View B—Incentive-Based Capital Allocations Are Not in Scope of Topic 606 Because They Are Ownership Interests and Should Be Accounted for under Other GAAP

23. Supporters of View B think that the arrangements should be accounted for as an ownership interest in accordance with other GAAP. The nature and substance of the arrangement considering the GP's interest held in the partnership (a legal entity) and the definition of a *financial asset* in GAAP cause some stakeholders to assert that these arrangements are outside of the scope of Topic 606 on the basis of the scope exceptions in paragraph 606-10-15-2 for financial instruments. When determining the accounting to use for carried interest, View B supporters would evaluate Topic 810, Consolidation (specifically, whether the fund is a variable interest entity or voting interest entity and, if applicable, whether the interest is a variable interest), Topic 323, Investments—Equity Method and Joint Ventures (specifically, whether significant influence is achieved), and the definition of a financial asset. In GAAP, the term *financial asset* is defined as the following (first definition):

> Cash, **evidence of an ownership interest in an entity**, or a **contract that conveys to one entity the right to** do either of the following:
>
> a. **Receive cash** or another financial instrument from a second entity
>
> b. Exchange other financial instruments on potentially favorable terms with the second entity. [Emphasis added.]

24. Based on this definition, supporters of View B assert that an asset manager's investment in the limited partnership, either as a general or a limited partner, meets the definition of a financial asset. Supporters of this view assert that carried interest represents an allocation of profits from the LPs based on the performance of the underlying portfolio investment and, therefore, it is more akin to a financial asset rather than revenue from a contract with a customer. View B supporters also note that accounting for the arrangement as a financial asset would provide symmetry with the accounting at the underlying fund for which the GP's investment is reflected at its current fair value. View B supporters also note that the scope guidance in other GAAP (for example, Topic 323) was not amended as a result of Update 2014-09.

25. Under View B, questions might arise about the presentation of changes in carried interest in the income statement. If carried interest is accounted for as an ownership interest, then it might not be acceptable under GAAP to present changes in carried interest as performance fee revenue.

View C—Entity Should Account for Carried Interest Either as a Revenue Arrangement under Topic 606 or as an Ownership Interest in Accordance with Other GAAP on the Basis of the Nature and Substance of the Arrangement

26. Supporters of View C observe that carried interest arrangements include elements of provision of services, as well as ownership interests. Proponents of this view believe asset managers should evaluate the nature and substance of their arrangements, evaluate the scope of the accounting guidance in various Topics, and apply judgment based on the nature and substance of the arrangement in determining its accounting policy for the arrangements.

27. Proponents also believe that clear disclosure about the asset manager's accounting policy would provide financial statement users with sufficient information to understand the asset manager's financial statements and to make comparisons to other asset managers that apply a different accounting policy.

Staff Analysis and View

28. Consistent with the FASB's previous outreach efforts with asset managers, preparers in the most recent outreach have diverse views about whether Topic 606 would produce useful information for investors. Preparers that apply Method 1 today generally objected to View B; preparers that apply Method 2 today generally objected to View A.

29. Despite having diverse views about whether Topic 606 would provide useful information in asset managers' financial statements, almost all stakeholders with whom the staff has spoken think that the Board's intention is that asset managers are within the scope of Topic 606. Those stakeholders include preparers that apply Method 1 and Method 2 today and auditors of asset managers.

30. The staff is aware that many preparers think that the incentive-based fees received in these arrangements are related to performance and represent compensation for services provided. In addition, many asset managers that attended the workshop on January 7, 2016 thought that the accounting for the arrangements should be based on the economic substance of the arrangements and not on the legal form of the arrangements. In other words, stakeholders generally do not think two different accounting models should apply depending on the legal form of the arrangement.

31. During the course of the revenue project, the Boards discussed the application of the new revenue model to asset managers at public joint Board meetings on several occasions as well as during outreach meetings with the asset manager industry. Most of that discussion was about the financial reporting that would result from applying the new revenue model (particularly the constraint on variable consideration), not about whether another area of GAAP would apply.

32. Several stakeholders expressed concern with the effect that View B might have on an asset manager's consolidation analysis under Topic 810, particularly about whether a carried interest is a variable interest and, if so, whether the GP would be the primary beneficiary of a limited partnership that is a variable interest entity. The Accounting Standards Update 2015-02, *Consolidation (Topic 810)—Amendments to the Consolidation Analysis* (Update 2015-02), revised the consolidation model in determining how to evaluate the primary beneficiary in a variable interest entity

(VIE). In Update 2015-02, the Board determined that fees paid to a decision-maker shall be excluded from the evaluation of the economics criterion when evaluating if a decision-maker is a primary beneficiary in a VIE if certain criteria are met. Some supporters of View A assert that accounting for these fees as an equity interest would be inconsistent with (or at least would raise questions about) the conclusions in Update 2015-02 about decision-maker fees. The staff highlights this as an example solely for the purpose of comparing View B to conclusions reached in Update 2015-02, and the staff does not intend for this paragraph to imply that asset managers always would reach a particular accounting treatment when evaluating these contracts (that is, the variable interest model versus the voting interest model).

33. The staff's view is that incentive-based capital allocations are within the scope of Topic 606. The staff's view primarily is based on the following considerations:

(a) Example 25 in Topic 606 illustrates the Board's intention about how the new revenue model would be applied to an asset manager services contract that includes a performance-based incentive fee. While the example does not state that the form of the incentive fee is a capital allocation or cash (or some other asset), the staff does not think that the arrangement is within or outside of the scope of Topic 606 depending on whether the fee is payable by cash or via carried interest.

(b) Carried interest is designed to compensate an asset manager for the services it performs in managing and investing in the fund. View A is consistent with previous Board decisions about these arrangements and results in a consistent treatment within the asset management industry and relative to service contracts in other industries.

(c) In Update 2015-02, the Board excluded performance-based fees from the analysis in determining the primary beneficiary of a VIE if (i) the compensation was commensurate with the services provided and (ii) the service agreement included only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length. The basis for that decision was that service arrangements that meet these two previously mentioned criteria are inherently different from other types of variable interests because that type of compensation does not subject the reporting entity to risk of loss. The risks associated with performance-based fees are only the opportunity costs of the nonreceipt of fees and not the actual exposure to losses. The staff's understanding is that during the deliberations of Update 2015-02, the Board's intent was that carried interest arrangements represent decision-maker fees for services and not an ownership interest.

34. In the staff's view, the services provided for incentive-based capital allocations, such as carried interest, are similar to services provided for separately managed accounts or non-U.S. corporations in which incentive-based performance fees are received in cash. The staff's understanding is that the legal form of asset management contracts can vary significantly. Some stakeholders have informed the staff that there is a risk that View B could result in an entity structuring its investment management arrangements (that is, by having compensation be paid via an equity interest) to circumvent the revenue model in Topic 606. Consequently, some stakeholders assert that some management contracts that are economically similar would be accounted for differently.

Question for the TRG Members

1. What are the views of TRG members about whether incentive-based capital allocations, such as carried interest, are within the scope of Topic 606 or should be accounted for under other GAAP?

Appendix A—Relevant Guidance

> > > *Example 25—Management Fees Subject to the Constraint*

606-10-55-221 On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

606-10-55-222 The entity accounts for the services as a single performance obligation in accordance with paragraph 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

606-10-55-223 At contract inception, the entity considers the guidance in paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity observes that the promised consideration is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

606-10-55-224 At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception—the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. At March 31, 20X8, the client's assets under management are $100 million. Therefore, the resulting quarterly management fee and the transaction price is $2 million.

606-10-55-225 At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 606-10-32-28. Consequently, the entity recognizes $2 million as revenue for the quarter ended March 31, 20X8.