

# Asset Management Spotlight

## Constituents Share Views on Three FASB Proposals

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## The Bottom Line

- In the last quarter of 2011, the FASB issued three exposure drafts (EDs) that could significantly affect the asset management industry, including hedge fund, equity fund, and mutual fund managers. The proposals could change when an asset manager recognizes revenue, whether an asset manager should consolidate funds that it manages, and whether those funds qualify for the specialized accounting afforded to investment companies.
- The first ED,<sup>1</sup> issued on October 21, 2011, would amend the investment-company criteria in ASC 946.<sup>2</sup> (Note that investment companies are referred to as ICEs for the remainder of this document.) However, most constituents were concerned about the proposed criteria, especially the pooling-of-funds criterion and the multiple-investments requirement, as well as about the proposed consolidation requirements related to fund-of-funds structures. Comments on this ED were due by February 15, 2012.
- Two weeks later (on November 3, 2011), the FASB issued an ED<sup>3</sup> that would provide guidance on determining whether a decision maker is acting as a principal or as an agent when performing a consolidation analysis. This proposal would amend the guidance on consolidation of a variable interest entity (VIE), the partnership consolidation model, and the definitions of participating and kickout rights. The comment period for this ED also ended on February 15, 2012; respondents generally supported the proposal.
- Finally, on November 14, 2011, the FASB and IASB jointly issued a revised ED<sup>4</sup> that proposes a new model for accounting for revenue arising from contracts with customers. The proposed guidance would supersede most of the current industry-specific revenue recognition guidance for asset managers. Respondents from the asset management industry voiced a number of concerns regarding this proposal. The comment letter deadline for the revised ED was March 13, 2012.

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<sup>1</sup> FASB Proposed Accounting Standards Update, *Financial Services — Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*.

<sup>2</sup> For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification."

<sup>3</sup> FASB Proposed Accounting Standards Update, *Consolidation (Topic 810): Principal Versus Agent Analysis*.

<sup>4</sup> FASB Proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue From Contracts With Customers*.

# Beyond the Bottom Line

## Investment Companies ED

On October 21, 2011, the FASB issued an ED that would amend the ICE criteria in ASC 946. An entity that meets the six proposed ICE criteria would measure its investment assets at fair value. However, in a fund-of-funds structure, an ICE would be required to consolidate a controlling financial interest in another ICE or in an investment property entity. The ED would also amend the presentation requirements for investments in real estate and would require additional disclosures.

The ED is the result of a joint project with the IASB to converge the boards' guidance on ICEs. In August 2011, the IASB issued an ED<sup>5</sup> that prescribes similar, but not identical, criteria for determining whether an entity is an ICE. The FASB's proposal also differs from the IASB's proposal on topics such as (1) an ICE's accounting for a controlling financial interest in another ICE in a fund-of-funds structure and (2) a non-ICE parent's retention of specialized industry accounting upon consolidation of an ICE subsidiary.

See Deloitte's October 21, 2011, [Heads Up](#) for more information about the provisions of the FASB's ICE ED.

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## Comment Letter Themes Related to Investment Companies

The FASB received over 90 comment letters and held five roundtables on the ICE proposal. Respondents included asset managers, banks, insurance companies, accounting firms, various industry associations, and academics.

### *Definition of an ICE*

Although most respondents agreed that the ED's ICE-qualifying criteria are generally appropriate, many were concerned that it would be onerous for entities to have to meet all six criteria and that certain entities that should be accounted for as ICEs, or that currently apply ICE accounting, could be precluded from qualifying. Further, some respondents suggested that the proposed criteria are too rules-based and recommended that a more principles-based model be used instead. Others agreed with the Board's approach but thought that some of the criteria should be modified.

### *Nature of Investment Activities*

Under the nature-of-investment-activities criterion, an ICE's only substantive activities must be to invest in multiple investments for returns from capital appreciation, investment income, or both. Many respondents requested additional clarification of this criterion (particularly as it relates to construction and loan origination activities). Most respondents commented on the "multiple investments" requirement, pointing out that funds are often set up to invest in a single asset for various reasons (e.g., several investors may form a fund to invest in an asset for which either minimum investments or the risks associated with holding the investment would otherwise be too great). These respondents believed that such entities have the same investment objective as entities with multiple investments and therefore that the fair value information for the single investment would still be relevant to financial statement users.

### *Express Business Purpose*

The express-business-purpose criterion requires that an ICE have an exit strategy for its investments. This exit strategy should illustrate that the ICE's express business purpose is to earn capital appreciation through investments. The ED further indicates that "[d]isposal of investments only during liquidation or to satisfy investor redemptions are not exit strategies." Some constituents were concerned that this requirement would exclude limited-life entities from qualifying as ICEs since these entities may not dispose of their investments until they are liquidated. In addition, some constituents questioned whether index funds would meet the exit strategy requirement because such a fund may only dispose of an investment when the security has been removed from the index.

<sup>5</sup> IASB Exposure Draft, *Investment Entities*.

Many respondents expressed concerns about the multiple-investor requirement, believing that it is common for ICEs to have a single investor.

### *Pooling of Funds*

Under the pooling-of-funds criterion, an ICE “must have investors that are not **related parties** of the entity’s **parent** (if there is a parent) and those investors, in aggregate, must hold a significant ownership interest in the entity.” Many respondents expressed concerns about the multiple-investor requirement, believing that it is common for ICEs to have a single investor. They emphasized that this criterion may inappropriately preclude certain entities from applying ICE accounting, such as co-investment vehicles, employee funds, sovereign wealth funds, insurance company separate accounts, and certain funds established for benefit plans. Some respondents recommended that rather than requiring significant ownership interest by other investors, the Board should develop a robust definition of the “nature of investment activities” and “express business purpose” criteria, since this would prevent situations in which an ICE is inserted into a larger corporate structure to avoid consolidation of the ICE’s controlled investees.

### *Unit of Ownership*

To meet the unit-of-ownership criterion, an entity must issue interests to equity holders or partnership interests to qualify as an ICE. Many respondents advised the Board to modify this criterion to include all residual interests. They believed that certain structures, such as collateralized debt obligations and collateralized loan obligations, that would otherwise qualify as ICEs would be inappropriately excluded if they did not have significant equity outstanding. Some respondents also noted that it is not uncommon for ICEs in certain jurisdictions to issue only debt interests to receive favorable tax treatment. Respondents stressed that this criterion would complicate the determination of whether an entity is an ICE because it would require entities to evaluate whether their ownership interests meet the definition of equity under U.S. GAAP before they evaluate this criterion.

### *Fair Value Management*

The fair value management criterion requires that substantially all of an ICE’s investments be managed on a fair value basis. While respondents generally agreed that fair value management is important, they questioned how this criterion would be evaluated in practice. In addition, some respondents disagreed with the FASB’s view that money market funds are managed on a fair value basis, stating their belief that such funds are typically managed to maximize yields.

### *Consolidation in a Fund-of-Funds Structure*

Although some respondents agreed that consolidation of controlled ICE investees in a fund-of-funds structure could result in more relevant information and limit structuring opportunities (particularly when the investee fund is wholly owned by the investor fund), most respondents did not support this proposal, indicating that consolidated information would not be meaningful for financial statement users and would add unnecessary complexity to the financial statements. These respondents instead believe that the measurement of controlling financial interests in other ICEs at fair value, when accompanied by additional disclosures, would constitute more relevant information and allow for comparability with other noncontrolled investments carried at fair value. They further indicated that it may be difficult to obtain timely information needed for consolidation and that consolidation conclusions could continually change when investors in the investee entity redeem interests or invest in the entity. Some respondents suggested that consolidation is only appropriate in certain cases, such as when controlling financial interests in ICEs are specifically formed for legal, tax, or other regulatory purposes (e.g., a blocker fund).

The FASB also received comments regarding the Board’s proposal not to require consolidation in a master-feeder structure. While there were some concerns about the inconsistency of this requirement with the requirement for an ICE to consolidate a controlling financial interest in a fund-of-funds structure, most respondents concurred with the Board’s proposal, agreeing that the current disclosure and presentation requirements for financial statements of registered feeder-funds are sufficiently

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transparent. Some noted that this requirement should be expanded to include nonregistered investment companies. In addition, respondents requested clarification of the terms "master-feeder fund" and "fund-of-funds structures" because of diversity in how these terms are used in practice.

Many respondents also noted that under the IASB's proposal, controlling financial interests in other ICEs would always be measured at fair value. They stressed the importance of the FASB's and IASB's convergence on this topic.

### ***Retention of Specialized Accounting***

Most respondents agreed with the ED's requirement that a non-ICE parent should retain, in its consolidated financial statements, the specialized accounting applied by its ICE subsidiary. Accordingly, an ICE subsidiary's investees would be measured at fair value in the non-ICE parent's consolidated financial statements. They argued that this requirement would result in more useful information, noting that if fair value measurement is relevant to the ICE subsidiary, it would also be relevant to the financial statements of the non-ICE parent.

A few respondents disagreed with the ED and agreed with the IASB's proposal that a non-ICE parent should not retain the specialized industry accounting upon consolidation of an ICE subsidiary. However, these respondents generally thought it would be appropriate to limit the circumstances in which the ICE-specialized accounting would not be retained. Most respondents believed that it is important for the FASB and IASB to converge on this topic.

### **ED on Consolidation: Principal-Versus-Agent Analysis**

On November 3, 2011, the FASB issued an ED that would provide guidance on assessing whether a decision maker is acting as a principal or as an agent when performing a consolidation analysis. The proposal, which would replace the indefinite deferral in [ASU 2010-10](#)<sup>6</sup> for interests in certain entities, would amend the criteria for determining whether an entity is a VIE and, if so, whether a reporting entity is the VIE's primary beneficiary; revise the definitions of participating and kick-out rights; and amend the evaluation of partnerships for consolidation.

While the FASB's consolidation project was initially intended to address interests in entities that qualified for the deferral in ASU 2010-10, the proposed guidance may affect the consolidation conclusions for all entities evaluated under ASC 810-10. The final standard is expected to affect whether asset managers are required to consolidate investment funds that they manage.

### **Comment Letter Themes Related to Principal-Versus-Agent Proposal**

The Board received over 60 letters on this proposal. The majority of respondents were financial institutions, including asset managers and other entities with investments that currently qualify for the deferral in ASU 2010-10.

### ***Overall Model***

The ED contains a new model for using judgment to qualitatively assess whether a decision maker (or a general partner) is a principal or an agent. When performing this qualitative assessment, an entity would be required to consider the (1) rights held by others, (2) fees paid to the decision maker, and (3) decision maker's exposure to variability of returns from its other interests.

See Deloitte's November 4, 2011, [Heads Up](#) for more information about the provisions of the FASB's principal-versus-agent ED.

While many respondents were concerned that the qualitative assessment could result in inconsistent and incomparable consolidation conclusions, others (particularly asset managers) agreed that management should exercise judgment as part of the analysis.

<sup>6</sup> FASB Accounting Standards Update No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*.

Respondents generally agreed that in performing the principal-versus-agent assessment, a reporting entity should consider the direct and indirect interests that a decision maker holds in an entity through the decision maker's related parties.

Some respondents believed that the ED's specific implementation examples would create inappropriate "bright lines" for (1) how to weigh each factor in the analysis and (2) the level of economic interest that would result in consolidation.

Some respondents suggested that additional factors be considered as part of the qualitative assessment, including the purpose and design of the entity, the legal/fiduciary responsibility of the manager, the scope of a decision maker's authority over an entity, and the establishment of a board of directors in accordance with the Investment Company Act of 1940.

### ***Rights Held by Other Parties***

Many respondents agreed with the FASB's proposal that the evaluation of rights held by other parties should take into account the number of parties required to act together and whether there are any barriers to exercising those rights. However, many commented that substantive kick-out and participating rights should be determinative that the decision maker is an agent, even when multiple parties are required to act together to exercise the rights. Some respondents argued that even if the rights are seldom exercised, the possibility that they may be exercised will influence the actions of a decision maker (i.e., the decision maker does not have unilateral control). Others agreed with the Board's position that when multiple unrelated parties hold such rights, this should only be one factor in the analysis and should not be determinative.

### ***Interests Held Through Related Parties***

Respondents generally agreed that in performing the principal-versus-agent assessment, a reporting entity should consider the direct and indirect interests that a decision maker holds in an entity through the decision maker's related parties. However, many were concerned that the examples in the ED do not address a number of issues associated with evaluating indirect interests held through related parties, such as economic interests held by an entity under common control.

In addition, many respondents disagreed with the ED's proposal that a reporting entity consider interests held by a decision maker's employee benefit plans in evaluating the decision maker's economic exposure to an entity. These respondents argued that employee benefit plans are established for the benefit of employees and that interests held by the plan should be excluded from the analysis.

### ***Effect on Money Market Funds***

As indicated in the ED, the FASB did not intend to require asset managers to consolidate money market funds (MMFs). However, many constituents were concerned that, on the basis of examples in the ED, it would be difficult to argue that the manager does not have an implicit guarantee to ensure that an MMF operates as designed, which could lead to consolidation of MMFs under the proposed guidance. Therefore, many respondents suggested that MMFs be excluded from the scope of the proposal, as is the case under current U.S. GAAP. Some asset manager respondents also indicated that the FASB should consider the SEC's proposed regulatory reform related to MMFs before finalizing the ED.

### ***Other Comments***

The proposal would also amend the consolidation model for partnerships and would require the decision maker, typically the general partner, to perform the same qualitative assessment to determine whether it acts as an agent or a principal. Most respondents agreed that a general partner should apply the principal-versus-agent analysis when evaluating its relationship with a limited partnership or similar entities. This change would move U.S. GAAP closer to a single consolidation model. Nevertheless, many respondents were unsure of how to apply the consolidation model when the general partner is deemed an agent and asked the Board to clarify whether a limited partner could be required to consolidate the partnership if the general partner is an agent.



The FASB and IASB jointly issued a revised ED that proposes a new model for entities to use in accounting for revenue arising from contracts with customers.

Although a number of respondents commented that redemption rights should be considered in the consolidation analysis, views on this issue varied. Some argued that redemption rights are equivalent to liquidation rights, while others believed that redemption rights should only be considered when they would result in the liquidation of the entity.

Finally, a few respondents asked about how to apply the proposed consolidation guidance to series funds — specifically, whether mutual funds that are established in a series structure would meet the definition of a VIE and, if so, how the primary beneficiary would be determined.

### ***Effective Date and Early Adoption***

The FASB has not established an effective date for this proposal and will consider feedback on the proposed amendments before setting one. There were mixed views on whether early adoption should be permitted; most respondents thought that entities would need at least one year to implement the final standard.

## **Revenue Recognition Revised ED**

On November 14, 2011, the FASB and IASB jointly issued a revised ED that proposes a new model for entities to use in accounting for revenue arising from contracts with customers. The proposed guidance would supersede most of the current industry-specific revenue recognition guidance for asset managers. Accordingly, the proposal could affect how an asset manager recognizes revenue from service contracts, including management, advisory, distribution, shareholder, transfer agent, and custodian fees.

In addition, the revised ED provides guidance on how to recognize revenue when an arrangement is satisfied continually (typically service contracts), including permitting revenue to be recognized on the basis of the amount that an entity has the right to invoice the customer. The revised ED would give entities greater flexibility to estimate the transaction price when arrangements for variable consideration are satisfied continually; however, in such cases, entities could only recognize the amount of consideration to which they are reasonably assured to be entitled.

See Deloitte's November 15, 2011, *Heads Up* for more information about the provisions of the revised ED on revenue recognition.

### **Comment Letter Themes Related to Revenue Recognition Proposal**

The Board received over 300 letters on this proposal. Respondents included stakeholders from various industries, with constituents from the asset management industry voicing a number of concerns. These concerns included identifying the customer related to the revenue contract (i.e., whether the customer is the fund or a third-party investor).

#### ***Performance-Based Fees***

Many asset managers raised concerns about removing the guidance in ASC 605-20-S99 (formerly EITF Topic D-96<sup>7</sup>), which describes two acceptable methods for recognizing revenue in performance-based fee arrangements. Respondents that currently apply Method 2<sup>8</sup> were concerned that limiting recognition to the amount to which the entity is reasonably assured to be entitled may cause revenue recognition to be deferred. In situations in which the performance fee is subject to clawback provisions, revenue may be deferred until long after the fees have been received by the asset manager. They pointed out that this timing may be inconsistent with when the asset manager recognizes payments to employees as compensation and would not result in meaningful financial reporting (this could result in an increase in the use of non-GAAP measures).

<sup>7</sup> EITF Topic No. D-96, "Accounting for Management Fees Based on a Formula."

<sup>8</sup> Under Method 2, an entity records performance-based fee revenue for the amount that would be due under the arrangement at any point in time as if the contract was terminated on that date.

The boards are expected to begin redeliberating all three projects in the near term. However, the issuance and effective dates of the final standards remain uncertain.

Some respondents indicated their belief that performance-based fees may be reasonably assured and therefore not subject to the constraint on the amount of revenue that may be recognized, even if the final revenue amount is subject to volatility in the marketplace. They requested the FASB to confirm whether the listed indicators (including volatility in the marketplace) are determinative that the amount is not reasonably assured. Other asset managers agreed with the Board's decision to eliminate Method 2, noting that the proposed model better reflects the economic performance of the asset manager. In addition, some respondents questioned whether carried interests are within the scope of the revised ED.

### ***Up-Front Fees***

Asset managers may own a broker that distributes sponsored products. For front-end loaded distributions, there is generally an up-front fee (initial sales fee) that investors pay to the broker upon subscription to the fund. Some respondents were concerned that the revised ED would delay the recognition of up-front fees. They believed that if up-front fees were determined not to represent a separate performance obligation (i.e., not to result in the transfer of a promised service), revenue recognition would be deferred. This would be a change from current practice.

### ***Third-Party Fees***

Some respondents questioned the accounting for fees paid to third parties to distribute the asset managers' products. These fees include sales commissions, marketer fees or trailing commissions, and placement fees. Respondents questioned whether the fees would be considered incremental costs incurred in obtaining a contract (which would be deferred as assets and amortized in a manner consistent with the pattern of transfer of services) or costs for fulfilling the performance obligation under the contract (which would be expensed as incurred). Other respondents thought that the fees paid to third parties should be excluded from the scope of the revised ED.

### ***Disclosures***

While respondents generally supported the practical expedients added to the disclosure requirements since the previous June 2010 ED, several respondents suggested that the disclosure requirements should be more principles-based. In particular, asset managers noted that some of the disclosures required by the revised ED may not be relevant or useful to financial statement users. They believed that the time, effort, and cost related to complying with the revised ED's disclosure requirements would outweigh the benefits.

## **Thinking Ahead**

The FASB and IASB recently hosted public roundtables to obtain additional feedback from constituents on the ICE proposal and plan to hold a number of roundtables on the revenue proposal as well. The boards are expected to begin redeliberating all three projects in the near term. However, the issuance and effective dates of the final standards remain uncertain. Most constituents suggested that preparers would probably need substantial time to implement the three proposals.

Given the significant concerns raised by constituents on all three projects, it appears likely that the FASB will have to carefully consider how best to proceed. During this time, asset managers should continue to monitor the FASB's progress and to actively participate in the standard-setting process.

## Contacts

If you have questions about this publication, please contact the following Deloitte industry professionals:

**Jim Schnurr**

AERS Partner  
Deloitte & Touche LLP  
+1 203 761 3539  
[jschnurr@deloitte.com](mailto:jschnurr@deloitte.com)

**Brian Gallagher**

AERS Partner  
Deloitte & Touche LLP  
+1 617 437 2398  
[bgallagher@deloitte.com](mailto:bgallagher@deloitte.com)

**Robert Fabio**

AERS Partner  
Deloitte & Touche LLP  
+1 516 918 7285  
[rfabio@deloitte.com](mailto:rfabio@deloitte.com)

**Maryna Tully**

AERS Partner  
Deloitte & Touche LLP  
+1 609 806 7022  
[matully@deloitte.com](mailto:matully@deloitte.com)

**Trevor Farber**

AERS Partner  
Deloitte & Touche LLP  
+1 203 563 2547  
[tfarber@deloitte.com](mailto:tfarber@deloitte.com)

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