

# Revenue recognition in the asset management industry

The asset management industry will have new challenges in valuing its investees when the new revenue standard in Accounting Standards Codification (ASC 606), *Revenue from Contracts with Customers*, is adopted. In general, the industry has relied on the scope exception outlined in ASC 606-10-15-2 that specifies that the new guidance on revenue from contracts with customers does not apply to financial instruments. As a result, the industry has presumed that the new revenue recognition standard will have no or minimal impact on the financial statements of the funds that the investment advisors provide to their investors.

However, this view fails to recognize the impact that the changing standards may have on the funds' investee companies.

Specifically, the financial data that funds utilize in valuing Level 3 securities may change significantly depending on the individual investee, as well as the industry within which the investee operates. Additionally, due to the different transition methods available for applying the new standard, as well as the different timing that individual industry participants may elect for adoption of the new standards, comparability of data across different industry players may be challenging during the transition period.



## The new revenue standard: the basics

The principles in the standard will be applied using a five-step model that requires companies to exercise judgment when considering the terms of the contract(s) and all relevant facts and circumstances. These requirements will need to be applied consistently to contracts with similar characteristics and in similar circumstances.

### Step 1

#### Identify the contract(s) with a customer

The model applies to each contract with a customer that meets the attributes of a contract, as defined. Contracts may be written, verbal or implied by customary business practices but must be legally enforceable and have commercial substance. An entity must conclude it is probable that it will collect substantially all of the consideration to which it will be entitled for the goods or services that will be transferred to the customer. This includes considering the customer's ability and intention to pay the consideration due and the entity's ability to mitigate its credit risk.

An entity should combine two or more contracts that it enters into at or near the same time with the same customer and account for them as a single contract, if they meet specified criteria. The standard provides detailed requirements for contract modifications. Depending on the facts and circumstances, a modification may be accounted for as a separate contract, part of the existing contract or a termination of the original contract and the creation of a new contract.

### Step 2

#### Identify the performance obligations in the contract

An entity will then evaluate the terms and its customary business practices to identify which promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations.

The key determinant for identifying a separate performance obligation is whether a good or service (or a bundle of goods or services) is distinct. A good or service (or bundle) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and the good or service is separately identifiable from other promises in the contract. Each distinct good or service (or bundle) will be a single performance obligation.

An entity may provide a series of distinct goods or services that are substantially the same and have the same pattern of transfer. Examples include services provided on an hourly or daily basis. If the specified criteria are met, such a series is considered a single performance obligation.



### Step 3

## Determine the transaction price

**The transaction price is the amount of consideration to which an entity expects to be entitled and considers:**

- ▶ An estimate of any variable consideration (e.g., amounts that vary due to rebates, concessions or bonuses) using either a probability-weighted expected value or the most likely amount method, whichever better predicts the amount of consideration to which the entity will be entitled subject to the constraint. That is, the standard limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.
- ▶ The effect of the time value of money is excluded, if there is a significant financing component in the contract.
- ▶ The fair value of any noncash.
- ▶ Consideration.
- ▶ Consideration payable to the customer reduces the transaction price, unless the payment to the customer is in exchange for a distinct good or service.

### Step 4

## Allocate the transaction price to the performance obligations

An entity must allocate the transaction price to each separate performance obligation on a relative stand-alone selling price basis, with limited exceptions. One exception in the standard permits an entity to allocate a variable amount of consideration, together with any subsequent changes in that variable consideration, to one or more (but not all) performance obligations or distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation, if specified criteria are met.

When determining stand-alone selling prices, an entity must use observable information, if it is available. If stand-alone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Examples of estimation approaches include an adjusted market assessment approach or an expected cost plus a margin approach.

As explained in the standard, the residual approach can be used only when the stand-alone selling price of a good or service is highly variable or uncertain. However, the standard does not prescribe any particular technique for applying the residual approach.

Whichever estimation approach is selected, it must be consistent with the notion of a stand-alone selling price, maximize the use of observable inputs and be applied on a consistent basis for similar goods or services and customers.

### Step 5

## Recognize revenue when or as the entity satisfies a performance obligation

An entity satisfies a performance obligation by transferring control of a promised good or service to the customer. The transfer can occur over time or at a point in time.

**A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:**

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- ▶ The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

**Assessing whether each criterion is met will likely require significant judgment.**

Revenue is recognized in line with the pattern of transfer. Revenue that is allocated to performance obligations satisfied at a point in time will be recognized when control of the goods or services has transferred. If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognized over the period the performance obligation is satisfied, using a method that depicts the pattern of the transfer of control over time.

### Key impacts of the new standard on a fund's investment valuation

The adoption of the new revenue recognition standard should not have an impact on any entity's fair value. However, careful consideration needs to be given to the inputs into the valuation to ensure consistency in valuation. Anyone who has ever been involved in the valuation of securities that utilize significant unobservable inputs knows that there are numerous inputs into the valuation models, much of which emanates from the financial data supplied by the underlying investee. In applying valuation approaches that rely on data from market comparables, the valuation method's basic premise relies on the fact that financial information is consistent over time and comparable across industry participants. Revenue and earnings before interest, tax, depreciation and amortization (EBITDA) multiple approaches are a core component of the market approach to valuation. For example, under the market approach, the private equity industry often utilizes its investee's financial results as a key input into the valuation. Changes (increases or decreases) in revenues or EBITDA from period to period are considered to be a result of change in the operations of the investee and are considered in evaluating changes in values for the fund's investment. An investor will need to evaluate whether changes in revenues or EBITDA are driven by the underlying investee's actual financial performance, the adoption of the new standard or a combination of both factors. In addition to the market approach, there is also a potential impact to the income approach. Forecasts are often developed based on trends in historical financial performance and market-comparable benchmarks. For instance, for companies that anticipate seeing a significant impact to deferred revenue resulting from the new guidance, the market-comparable company benchmarks need to be evaluated to understand if they are reporting working capital levels based on the new guidance or the prior guidance. Additionally, valuation models must consider how this deferred revenue adjustment should impact forecasted revenues.

During the period of transition to the new revenue standard, comparability will be challenged. Public companies are required to adopt ASC 606, *Revenue from Contracts with Customers*, beginning with fiscal periods beginning after 15 December 2017, and nonpublic entities beginning with fiscal periods beginning after 15 December 2018. Additionally, companies have the option to early adopt the new standard. In determining a valuation for a private investment, it is important to understand the timing of adoption for the new revenue recognition standard that is utilized by the private company, as well as the comparable set of companies used in the income and market approaches to valuation in order to identify and adjust for differences, if any, between the private investment and the comparables.

**Private equity entities, business development companies (BDCs) and hedge funds with private investments that utilized unobservable inputs in determining fair value will need to spend time for each investment to determine:**

- ▶ The most appropriate valuation approach for each investment
- ▶ The underlying investment's timeline for adoption of the new revenue standard
- ▶ The comparable set of companies for each investment
- ▶ The timeline for adoption of the new standard for each of the companies in the comparable set

Additionally, while public company comparisons are aided by the availability of annual and quarterly financial statements with robust disclosures regarding the implementation of the new standard, private company information is harder to come by. In the Guideline Transaction Method, the investment fund attempts to use transaction multiples to value its underlying investments; however, not having access to information regarding the revenue recognition adoption of the acquired entity may not provide complete information to developing the multiple.

Finally, the transition methodologies utilized by entities have the potential to be inconsistent. The standard allows for either full retrospective or modified retrospective adoption methodology. Essentially, entities can reflect the adoption by recording a cumulative effect adjustment in the year of adoption or by restating all periods presented. Additional information and disclosures are available depending on the methodology utilized in the financial statement footnotes, but once again, require the investor to make the extra effort to determine the impact of the new standard.

In light of the foregoing, understanding the new revenue standard's impact on the underlying investee becomes a critical component to the valuation of certain investments.







### Internal control considerations

The development and maintenance of valuation models are a critical component of a fund's system of internal controls. During this time of transition, a company's system of internal controls will also need to respond to these accounting changes. It is important that those individuals responsible for determining fair value gain an understanding of, and an appreciation for, the impact of the new standard in order for them to properly perform their control functions.



## Final thoughts

The adoption of the new revenue recognition standard in ASC 606 creates an additional burden on investment funds to understand how the standard impacts the valuations of its investments. Considerable time and effort will be required to determine how to adapt to the changes and adjust for inconsistencies between investees' financial information and financial information of comparable companies in specified valuation techniques. After the transition period, funds will also need to consider how the standard will impact the timing and amount of revenue recognition for each of its investees. Careful consideration will be needed to assess whether the trend in earnings is a reflection of operating performance or the impact of the accounting change. Early interaction with auditors and valuation professionals will be needed to ensure a smooth transition to the new standard.

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