

IFRS industry insights

IASB issues a revised exposure draft on revenue recognition – insights for the financial services industry

The revised ED is the next step in developing an entirely new revenue recognition standard.

In November 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly issued re-exposure draft ED/2011/6 *Revenue from Contracts with Customers* ('the revised ED'). The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and redeliberations on the proposals in the original ED that was issued in June 2010. Although the underlying conceptual basis is unchanged, the IASB and the FASB (collectively 'the Boards') changed many detailed aspects of the original ED's proposals. As a result of these changes, and given the importance of the revenue line item to users of financial statements, the Boards decided to expose for public comment a revised ED. The comment period ended on 13 March 2012. The effective date of the proposed standard will not be earlier than for annual reporting periods beginning on or after 1 January 2015, with the IASB permitting early application.

This IFRS Industry Insight publication highlights aspects of the revised ED that may affect the financial services industry and provides insight to assist in the assessment of the potential impact of these revised proposals. Many entities in the financial services industry earn revenues from fee generating activities such as investment banking and advisory services, wealth management advisory services and asset management services. These types of fee generating activities would be in the scope of the revised revenue recognition proposals.



Identifying separate performance obligations

Both the original and revised EDs propose that a good or service would be accounted for as a separate performance obligation if it is deemed 'distinct'. The revised ED refines the definition of 'distinct' and, except as explained below, a good or service is distinct if either of the following criteria is met:

- a) the entity regularly sells the good or service separately; or
- b) the customer can benefit from the good or service either on its own or together with resources that are readily available to the customer.

Notwithstanding those criteria, a good or service in a bundle of promised goods or services is not distinct, and therefore the bundle of goods or services would be treated as a single performance obligation, if both of the following criteria are met:

- a) the good or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
- b) the bundle of goods or services is significantly modified or customised in order to fulfill the contract.

The revised ED states that, as a practical expedient, an entity may account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

Entities in the financial services industry may earn fee revenue for various activities, including asset management, advisory services and providing access to capital.

Financial services entities will need to analyse carefully their client contracts to determine whether the services provided are distinct or should be combined into a single performance obligation.

Asset managers may be entitled to an asset management fee based on a percentage of assets under management and a performance-based incentive fee based on a percentage of the fund's return in excess of an established rate of return (e.g., 20% of excess returns once investors have received an 8% rate of return). Investment banks may be entitled to an upfront retainer fee when the contract is executed, incentive-based fees upon the successful completion of a transaction and other compensation such as interest revenue or fees for financing arrangements.

Financial services entities will need to analyse carefully their client contracts to determine whether the services provided are distinct or should be combined into a single performance obligation. This is particularly relevant for investment banking entities that may provide various services to a client such as advisory, securities underwriting and financing. Additionally, even though services in a contract may be distinct, an entity may decide to combine the services and account for them as a single performance obligation if those services have the same pattern of transfer to the customer.

Determining the transaction price

The original ED proposed that if the transaction price is subject to variability, an entity would be required to use a probability-weighted estimate of the transaction price if such an estimate can reasonably be made. The revised ED clarifies that "the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties." The transaction price would include discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, concessions and other similar items. The estimation would reflect available historical, current and forecast information and would be based on either the probability-weighted amount or the most likely amount (i.e., management's best estimate), "depending on which method the entity expects to better predict the amount of consideration to which it will be entitled." One method would need to be applied consistently throughout the contract.

Because of the contingent nature of many of the fee arrangements (e.g., event lending, performance-based fees, etc.), the calculation of the transaction price using a probability weighted approach may prove challenging because of the vast number of potential scenarios. If a contract includes multiple performance obligations and the transaction price includes a contingent amount, the entity would allocate that contingent amount and related subsequent changes entirely to one performance obligation (unlike the requirement proposed in the original ED to allocate subsequent changes in the transaction price to all performance obligations in the contract) when both of the following criteria are met:

- the contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or to a specific outcome from satisfying that separate performance obligation; and

- allocating the contingent amount entirely to that particular performance obligation is consistent with the revised ED's allocation principle, i.e., overall it reasonably reflects the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation.

If these criteria are not met, the contingent amount and subsequent changes in the transaction price would need to be allocated to all performance obligations. Amounts allocated to a satisfied performance obligation would be recognised as revenue, or as reduction of revenue, in the period in which the transaction price changes.

Example

An investment bank enters into a contract with a client. The contract includes two performance obligations, providing advisory services in identifying a strategic acquisition target and facilitating capital raising to complete the acquisition. The consideration is structured such that the investment bank receives a fixed fee of CU 250,000 for the advisory services and a fee of 1 per cent of the amount of financing raised to complete the acquisition. The stand alone price for advisory services is CU 250,000. The contingent payment terms of the contract relate specifically to the performance obligation associated with the capital raising. Therefore, none of the contingent consideration would be allocated to the performance obligation associated with advisory services. However, if the stand alone price for the advisory services were CU 400,000, this may imply that a portion of the consideration for the advisory services is contingent. If so, the investment bank would need to determine whether it should use a probability weighted approach or a most likely outcome approach for estimating the contingent transaction price and allocating it to both performance obligations.

Transfers of control over a period and measurement towards completion

The original ED introduced the concept of "control" in the determination of when a good or service transfers to a customer and, thus, when revenue is recognised, which may be at a point in time (e.g., delivering a good) or continually over a period (e.g., rendering a service). For an entity to recognise revenue over a period, it first must conclude that a performance obligation is continuously satisfied, and then it must select a method to measure progress toward completion.

Hedge fund managers may be required to wait until the fund's performance period has concluded while private equity and real estate fund managers may be required to defer the recognition of incentive fees for a significant period of time.

An entity satisfies a performance obligation continuously if at least one of the following criteria is met:

1. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g., the customer controls the work-in-progress).
2. The entity's performance does not create an asset with 'alternative use' to the entity (e.g., the contract does not allow the entity to sell the work-in-progress to another customer or the work-in-progress is highly customer-specific and would not be suitable for another customer) and at least one of the following criteria is met:
 - a. the customer simultaneously receives and consumes a benefit as the entity performs each task;
 - b. another entity would not need to substantially re-perform the work completed to date if that other entity were to fulfill the remaining obligation to the customer (without having access to work-in-progress, or any other asset, controlled by the entity); or
 - c. the entity has a right to payment (assuming that the seller complies fully with its contractual obligations) for performance completed to date and expects to fulfill the contract as promised. If the customer cannot cancel the contract, or the full contract price is payable on cancellation, this would appear to meet the criteria. If the contract can be cancelled by the customer and a fixed amount is payable on cancellation, which is lower than the total contract price, this may not be considered to be sufficient to compensate for performance to date and therefore may not satisfy this criterion.

Often it will be obvious whether the customer has control but there may be situations where it is not clear and factors will need to be considered, including, but not limited to, the entity's present right to payment for the work performed to date, whether the customer holds legal title to the work-in-progress and whether the customer has the significant risks and rewards of ownership of the work-in-progress.

Because the services provided by financial services firms generally are customer-specific, those services typically would not have an alternative use. Furthermore, depending on the nature of the service, one or more of the above criteria may be met resulting in the recognition of revenue over time. Investment banking entities that receive upfront fees (e.g., retainer fees) and asset managers or distributors in front-end loaded funds that receive an initial sales fee typically will not recognise revenue at the time the fee is received but rather over time as the related services are provided.

Constraining the cumulative amount of revenue recognised

For contracts with variable consideration, the revised ED takes a slightly different approach from that proposed in the original ED. The revised ED imposes a constraint on the cumulative amount of revenue recognised, being that this should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

- the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and
- the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

Investment banking fees are typically heavily weighted towards variable consideration upon successful completion of a transaction (e.g., a securities offering). Compensation arrangements may include an upfront cash retainer, a cash bonus upon closing of a transaction and, for initial public offerings, the receipt of warrants or other equity instruments. Similarly, many asset managers have a significant portion of their compensation tied to asset returns. A typical alternative asset management fee arrangement is a 2% annual management fee based on assets under management and an incentive fee of 20% of returns earned after the investors have reached an established rate of return. Certain asset managers, such as hedge fund managers, earn their incentive compensation annually based on the annual performance of the fund. However, other asset managers, such as private equity and real estate funds with a fixed investment period, may receive distributions for their incentive fees earned to date but those fees may be subject to 'clawback' provisions.

The proposals may result in deferral of these contingent fee revenues. For investment banking arrangements, the contingent consideration would not be recognised as revenue until such time as there is reasonable assurance that the entity is entitled to the consideration which may not occur until completion of the transaction. Hedge fund managers may be required to wait until the fund's performance period has concluded while private equity and real estate fund managers may be required to defer the recognition of incentive fees for a significant period of time.

The revised ED proposes that the incremental costs of obtaining a contract with a customer should be recognised as an asset if the entity expects to recover those costs.

Example

Assume an investment fund enters into a contract with an asset manager to provide asset management services for one year. The asset manager receives a quarterly management fee of 50 basis points based on the fund's assets under management (AUM) at the end of each quarter. The asset manager is also entitled to a performance-based incentive fee of 20% of the fund's returns once the investors in the fund have reached a hurdle rate of return.

The asset manager concludes that there is only one performance obligation. The asset manager determines that it has reasonable assurance that it will be entitled to receive the quarterly management fee as the amount of AUM is known at each quarter and the services have been completed to date.

However, the asset manager is not reasonably assured that it will be entitled to receive the performance fee until the end of the year. Whilst the asset manager has experience with other similar contracts, that experience is not predictive of this current contract because of market volatility outside of the asset manager's control. As a result, the cumulative amount of revenue recognised throughout the year is limited to the quarterly management fees. The asset manager measures the value of the services provided to date by reference to the quarterly management fee which is entitled to be invoiced. Once the performance period has completed at the end of the year and the investment fund performance is known, then the asset manager would be reasonably assured to receive any amount of incentive fees earned during the contract term.

Contract Costs

Costs of fulfilling a contract would be capitalised if "the costs relate directly to a contract (or a specific anticipated contract), the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future and the costs are expected to be recovered." Examples of such costs might include direct labour. However, general and administrative costs would generally not be capitalised. The revised ED also clarifies that the costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract (i.e., pre-contract costs).

Whereas the original ED proposed that costs of obtaining a contract should be expensed, the revised ED proposes that the incremental costs of obtaining a contract with a customer should be recognised as an asset if the entity expects to recover those costs. Incremental costs are the costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (for example, a sales commission). Costs that would have been incurred regardless of whether the contract was obtained should be recognised as an expense when incurred, unless they are explicitly chargeable to the customer regardless of whether the contract is obtained. As a practical expedient, acquisition costs incurred may be expensed instead of capitalised for those contracts with an expected duration of one year or less.

Capitalised costs should be amortised "on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates." The period may extend beyond the initial contract term with the customer (e.g., considering contract renewals and related subsequent services).

For investment banks, many of the costs incurred to establish and retain business relationships would likely not qualify for capitalisation. For asset managers, there may be a variety of costs incurred in attracting investors that would be subject to consideration for capitalisation. Private equity managers may have arrangements to pay 'placement fees' to placement agents who bring investors to the asset manager during capital raising periods and help to secure capital commitments; these would be one-time fees paid to the placement agent. Similarly, hedge funds or other asset managers may pay 'trailing commissions' to advisors for steering investors to their products, however these fees would continue to be paid in the future. Asset managers of closed-end mutual funds will also pay brokers who sell the funds' shares a deferred sales charge; these would typically be a one-time charge paid as the investor acquires the shares of the fund. Each of these types of arrangements may meet the criteria for capitalisation and amortised on a systematic basis as the services are transferred (or as incurred if the service period is less than twelve months). Capitalised costs would need to be assessed for impairment.

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