

**MEMO# 13541**

May 24, 2001

## **ADVISER ACCOUNTING FOR PERFORMANCE BASED INCENTIVE FEES**

[13541] May 24, 2001 TO: ACCOUNTING/TREASURERS COMMITTEE No. 14-01 RE: ADVISER ACCOUNTING FOR PERFORMANCE BASED INCENTIVE FEES At the April 18-19 meeting of the FASB's Emerging Issues Task Force, SEC staff made an announcement concerning investment adviser revenue recognition in connection with contracts that contain performance-based incentive fees. The SEC was asked to address adviser accounting for incentive fees received at interim dates before the end of the measurement period. The issue arises because of the possibility that fees earned by exceeding a performance benchmark early in the measurement period may be reversed due to missing performance targets later in the measurement period.<sup>1</sup> The SEC indicated that, based on an informal survey, many investment advisers do not record any incentive fee income until the end of the contract year ("year-end method"). However, certain advisers record as revenue the amount that would be due under the incentive fee formula at interim dates throughout the year as if the contract were terminated at that date ("interim method"). The SEC staff indicated that it would not object to either of these methods; however, the staff considers the former method to be preferable. Recognition at the end of the period is more consistent with Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, which indicates that the staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved. The SEC staff also would not object to the interim method. Since advisory contracts typically are terminable by either party, the performance fee may be viewed as realizable at interim dates. However, some advisers employ a variation of the interim method that the SEC staff would object to. This variation reduces the amount of revenue that would be recognized under the incentive fee formula to the extent management believes it is likely that a portion of the calculated amount will be lost due to future performance. The SEC staff would object to this method because it explicitly considers future performance in determining how much revenue to recognize. 1 Performance-based incentive fee arrangements for SEC registered investment companies typically incorporate a rolling 36-month measurement period. Under these arrangements, any performance-based incentive fee is added to (or deducted from) the basic fee at the end of the measurement period. See SEC Release No. IC-7113 (April 6, 1972). 2 Disclosure of the accounting policy used for performance-based incentive fee arrangements should be made in accordance with APB Opinion No. 22, Disclosure of Accounting Policies, and SAB No. 101. Advisers should disclose whether they have recorded any revenue that is at risk due to future performance contingencies, the nature of the contracts giving rise to the contingencies, and, if material, the amount of any such revenue recorded. The provisions of the SEC staff announcement should be applied no later than the beginning of the first fiscal quarter of the fiscal year beginning after December 15, 2001. If an accounting change is

required to conform to the staff announcement, that change should be calculated as of the beginning of the calendar quarter of adoption and presented as a cumulative effect of a change in accounting principle, as described in APB Opinion No. 20, Accounting Changes.  
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