Working Draft:

Broker-Dealer Revenue Recognition Implementation Issue

Issue #3-4: Underwriting Revenues

Expected Overall Level of Impact to Industry Accounting:

Minimal

Wording to be Included in the Revenue Recognition Guide:

Background:

1. Business entities and governmental entities that desire to raise funds through the public sale of securities normally engage securities broker-dealers to underwrite their securities issues. Underwriting is the act of distributing a new issue of securities (primary offering) or a large block of issued securities (secondary offering).

2. There are several different ways in which a broker-dealer may participate in the underwriting of securities. The broker-dealer may act as managing underwriter (commonly referred to as the lead underwriter), co-managing underwriter (or co-lead), or participating underwriter. Such participation may be on one of the following bases, though this does not represent an all-inclusive list:

   a. Firm commitment: The underwriting group for a transaction on a firm-commitment basis agrees to buy the entire security issue from the issuer for a specified price, whether or not they can successfully sell all purchased securities to investors. Typically, this type of commitment occurs immediately prior to the offering. However, broker-dealers may enter into a contract with an issuer that provides a firm commitment to underwrite securities several days or weeks prior to the actual offering.

   b. Best efforts: The underwriting group for a best-efforts basis agrees to sell the issue at a price to be determined, normally with a minimum requirement to complete the underwriting. Any securities for which the broker-dealer cannot obtain a purchase commitment for in the public market will not be underwritten (purchased) by the broker-dealer.

   c. Standby: The underwriting group for a standby basis commits to purchase securities only if called on.

3. The managing underwriter(s) are typically responsible for the following:

a. Organizing the other participating underwriters and the selling group[1] ;

b. Negotiating the transaction with the issuer of the security;

c. Maintaining the subscription records for the underwriting (such as, status of orders from customers); and

d. Maintaining a record of all direct expenses associated with the offering, including marketing and advertising fees, legal fees, and the other costs associated with setting up the syndicate group. These expenses are allocated to the other members of the syndicate on a pro rata basis. Refer to Issue No. 3-3: *Principal vs. Agent: Costs Associated with Underwriting for guidance on accounting for these expenses.*

4. Participating underwriters maintain records of each underwriting participation only to the extent they are involved. To spread the risk of an underwriting and facilitate its distribution, the underwriters may sell all or part of the securities directly to the public or a selling group that in turn sells the securities to the public. If an issue is not fully sold (in a firm commitment underwriting), the liability is shared among the participating underwriters through either an undivided or divided arrangement. An undivided liability is an arrangement whereby each member of an underwriting syndicate is liable for its proportionate share of unsold securities in the underwriting account regardless of the number of securities it has previously sold. A divided liability is an arrangement whereby each member is liable only for their "divided" or fixed share of the securities and not for any additional unsold securities beyond that amount. Selling groups are not underwriters and have no obligation to sell the securities allocated to them. Accordingly, they are entitled only to a selling concession.

5. The difference between the price paid by the broker-dealer to the issuer for the securities and the price paid by the public for the securities (the gross underwriting spread) represents the underwriters' and selling groups' compensation for the risk and cost of selling the issue. The gross underwriting spread is generally apportioned between the underwriters and selling group and represents the compensation for one or more of the following services which are specified in the underwriting agreement or term sheet.

   a. Management underwriting services: Underwriting services performed by the manager or co-managers (usually referred to as the lead or co-lead) in organizing the syndicate of underwriters and maintaining the records for the distribution (typically 20% of the spread);

   b. Underwriting services: Underwriting services performed by the underwriting participants (other than the lead managers) in committing to buy a specified portion of the issue and thereby assume the associated risk (typically 20% of the spread); and

   c. Selling concession services: Underwriting services performed by all of the underwriters in selling the offering (typically 60% of the spread).

   It should be noted that the split can be any combination agreed upon contractually and would not change the gross underwriting spread.

Scope

6. Underwriting revenues should be accounted for using the five step revenue recognition model within FASB ASC 606, *Revenue from Contracts with Customers*.

7. In certain transactions, the issuer grants the underwriters the option to sell investors more securities than originally planned by the issuer. This option is legally referred to as an over-allotment option and is commonly referred to as a "greenshoe option." The exercise of the over-allotment option is typically utilized when the demand for a security issue proves higher than expected and in situations where the offering is "oversubscribed" by investors. The exercise of this option is dependent on the trading activity of the underwritten shares and is usually exercised to cover a short position. The broker-dealer is not obligated to exercise this option and the exercise is solely at the discretion of the broker-dealer.

8. A broker-dealer should evaluate whether an over-allotment option meets the requirements of a derivative contract under FASB ASC 815. A broker-dealer will need to assess the facts and circumstances of the underwriting transaction in determining whether the over-allotment meets the requirements of a derivative contract under FASB ASC 815. If the

[1] A selling group is typically a group of institutions who help the issuer place a new issue without necessarily participating in the underwriting and therefore are not typically responsible for any unsold securities.

broker-dealer concludes that the over-allotment option is a derivative contract, the derivative contract should be accounted for under FASB ASC 815 and is therefore outside the scope of FASB ASC 606.

9. If the broker-dealer determines that the over-allotment is not a derivative contract, refer to paragraph 19 on the accounting for the over-allotment option under FASB ASC 606.

10. In addition to exercising the over-allotment option, broker-dealers may also purchase and sell shares directly in the market subsequent to the offering in efforts to stabilize fluctuating share prices by increasing or decreasing the supply of shares according to initial public demand. The broker-dealer is not contractually obligated to purchase and sell shares in the market. These stabilization activities are undertaken by the broker-dealer as part of the capital markets activities and there is no transfer of control of goods or services (i.e., there is no additional capital raised as a result of stabilization activities). Although the issuer may benefit from market stabilization activities, these activities are undertaken to benefit the broader capital markets as well as the broker-dealer and therefore in accordance with ASC 606-10-25-16 FinREC believes these activities do not represent an implied promise. All revenues associated with price stabilization conducted in the secondary market are not within the scope of ASC 606 and should be recognized in accordance with ASC 860: *Transfers and Servicing* and FASB ASC 940*: Financial Services—Brokers and Dealers*, as these revenues are related to proprietary trading activities. Refer to Issue No. 3-7: Revenue from Financial Instruments (Out of Scope) included in the paragraphs 5.7.01-5.7.04 of Chapter 5: Brokers and Dealers in Securities, of the AICPA Audit and Accounting Guide: *Revenue Recognition*.

Step 1: Identify the contract with a customer (paragraphs 1–9 of FASB ASC 606-10-25)

11. A broker-dealer enters an underwriting agreement when engaged in securities underwriting. The contract is commonly between a syndicate group, including the broker-dealer, and the issuer. A broker-dealer should evaluate the underwriting agreement to determine if the criteria within FASB ASC 606-10-25-1 are met. Generally, an executed underwriting agreement would illustrate that the contract has been approved, that each party's rights and payment terms are identified, and it has commercial substance. Broker-dealers should evaluate the facts and circumstances of the underwriting transaction when assessing the probability of collecting consideration from the issuer. FinREC believes underwriting contracts generally do not meet the criteria in FASB 606-10-25-1 until the underwriting agreement is executed and is legally enforceable.

12. As discussed in paragraph 5 of Issue No. 3-3: *Principal vs. Agent: Costs Associated with Underwriting*, FinREC believes that generally, the lead (or managing) underwriter is not acting as a principal to provide underwriting services for the overall issuance and therefore the lead underwriter should only record underwriting revenues in amounts related to their services and not include any revenues related to the services of the participating underwriters. Therefore, FinREC believes the issuer in a securities underwriting transaction is the customer of each of the underwriters within the syndicate group.

13. Broker-dealers may be engaged to provide services in addition to being engaged in underwriting securities. Such services could include providing bridge financing, term loans, or credit facilities.

14. A broker-dealer should consider the guidance in FASB ASC 606-10-25-9 to determine whether these service contracts and an underwriting agreement should be combined and evaluated as a single contract. Two or more contracts entered into at or near the same time with the same customer should be combined if one or more of the following criteria are met:

    a. The contracts are negotiated as a package with a single commercial objective.

    b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

    c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are determined to be a single performance obligation.

15. FASB ASC 606-10-15-4 describes how to separate and measure portions of the contract that meet the scope exceptions in FASB ASC 606-10-15-2 before applying the model.

Step 2: Identify separate performance obligations (paragraphs 14–22 of FASB ASC 606-10-25)

16. To determine the number of performance obligations in accordance with FASB ASC 606-10-25-14, broker-dealers must identify the promised services, either explicit in the contract or implied through customary business practices,

published policies, or specific statements that create a reasonable expectation of the issuer that the broker-dealer will transfer the service.

17. Typically, broker-dealers promise to perform multiple services in an underwriting agreement that may include a combination of management underwriting services, underwriting services, and selling concession services (see paragraph 5).

18. Promised services between a broker-dealer and an issuer that are distinct represent a performance obligation. Pursuant to FASB ASC 606-10-25-19, a service is distinct if (a) the customer can benefit from the service either on its own or together with other resources that are readily available to the customer and (b) the entity's promise to transfer the service to the customer is separately identifiable from other promises in the contract. FASB ASC 606-10-25-21 provides guidance for determining whether a service to a customer is separately identifiable.

19. Although a broker-dealer may perform different roles in the underwriting process, these services are essentially the same; the promised service is ultimately to raise capital for the issuer. These services are highly interrelated in that the issuer's ability to benefit is dependent upon the successful completion of all of individual promised services. FinREC believes the nature of securities underwriting services is raising capital on behalf of the issuer and will generally be accounted for as a single performance obligation.

20. In determining whether the over-allotment option is a separate performance obligation within the underwriting agreement, a broker-dealer will need to evaluate the enforceable rights and obligations of the underwriting agreement. When the over-allotment option does not meet the requirements of a derivative contract under FASB ASC 815, FinREC believes the over-allotment option is not a separate performance obligation until such option has been exercised (assuming the broker-dealer is not obligated to exercise this option). Upon the exercise of the option, the performance obligation is treated as a contract modification. FASB ASC 606-10-25-10 and 606-10-25-12 provides guidance on contract modifications and states, "a contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract…A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices…" Based on this, FinREC believes an entity should account for the exercise of an over-allotment option as a contract modification and a separate contract upon the exercise in accordance with FASB ASC 606-10-25-12 because the services from the issuance of shares under the over-allotment option are distinct and priced at the standalone selling price of underwriting services (i.e., the underwriting fees earned per share for the overallotment option are the same as those for the original issuance).

Step 3: Determine the transaction price (paragraphs 2–27 of FASB ASC 606-10-32)

21. FASB ASC 606-10-32-2 requires a broker-dealer to determine the transaction price as the amount of consideration it expects to be entitled to in exchange for transferring the service to the customer. Generally, a broker-dealer is able to determine the transaction price based upon the gross underwriting spread between the purchase price from the issuer and the sales price to a public investor, which is generally outlined within the executed underwriting agreement. The gross underwriting spread is apportioned to the broker-dealers in accordance with the underwriting agreement, which is generally based upon the services provided (i.e., management underwriting services, underwriting services, and selling concession services). As discussed in paragraph 5 of Issue No. 3-3: *Principal vs. Agent: Costs Associated with Underwriting*, FinREC believes that generally, the role of the lead underwriter with regard to services provided by the participating underwriters is that of an agent (i.e., arrangement of services). Consequently, in accordance with FASB ASC 606-10-55-38, the lead underwriter should record underwriting revenues net of revenues allocated to the participating members.

22. Paragraphs 5-13 of FASB ASC 606-10-32 requires broker-dealers to evaluate whether the underwriting agreement contains variable consideration, such as performance bonuses, incentives, or discounts. If so, the broker-dealer would need to estimate the amount of variable consideration and include such amount within the transaction price to the extent that it is probable that a significant reversal in cumulative revenue would not subsequently occur when the contingency is resolved. FASB ASC 606-10-32-12 provides factors a broker-dealer should consider when determining the amount of variable consideration to include in the transaction price.

Step 4: Allocate the Transaction Price to Performance Obligations (paragraphs 28–35 of FASB ASC 606-10-32)

23. FASB ASC 606-10-32-29 requires broker-dealers to allocate the transaction price to each performance obligation identified in the underwriting agreement based on the relative standalone selling prices for the services being provided to the issuer. FASB ASC 606-10-32-43 states that the transaction price is not reallocated to reflect changes in standalone selling price of the services after contract inception.

24. As noted within paragraph 19, with the exception of the exercise of the overallotment option, a securities underwriting service will generally have a single performance obligation, for which the entire transaction price determined in Step 3 will be allocated to. As noted within paragraph 20, the exercise of the overallotment option should be treated as a separate contract.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation (paragraphs 23–37 of FASB ASC 606-10-25)

25. In accordance with FASB ASC 606-10-25-27, a performance obligation is satisfied over time if one of the following criteria is met [analysis added]:

    a. The issuer simultaneously receives and consumes the benefits provided by the broker-dealer's performance as the broker-dealer performs the underwriting service.

       A broker-dealer should evaluate if another entity would not need to substantially reperform the work that the broker-dealer has completed to date if the other entity were to provide the securities underwriting services. That is, if another entity replaced the broker-dealer, would the other entity need to substantially reperform the broker-dealer's performance to date. In a typical securities underwriting arrangement, another entity would generally not rely upon the previous broker-dealer's services to date. Rather, the other entity would perform its own services, which may include its own due diligence of the issuer, sales and marketing activities with its own investors, and its own securities pricing analysis. Therefore, the performance of these activities prior to the underwriter purchasing securities from the issuer typically do not transfer a benefit to the issuer as those tasks are performed.

    b. The broker-dealer's performance creates or enhances an asset controlled by the issuer as the asset is created or enhanced.

       Securities underwriting services do not create or enhance an asset controlled by the issuer.

    c. The broker-dealer's performance does not create an asset with an alternative use to the broker-dealer, and the broker-dealer has an enforceable right to payment for performance completed to date.

       Securities underwriting services are unique to each issuer as the services are based upon the issuer's specific facts and circumstances. Generally, a broker-dealer would incur significant costs in redesigning the underwriting services for another issuer based upon that issuer's specific facts and circumstances. These services would not create an asset that the broker-dealer would be able to use in the future. To meet this requirement, a broker-dealer must also have an enforceable right to payment in an amount that approximates the selling price (i.e., recovery of its cost plus a reasonable margin) for services completed to date. In a typical underwriting agreement, a broker-dealer will not have an enforceable right to payment until the consummation of the securities issuance and therefore has no right to payment for the services performed prior to such date.

26. Based upon the analysis in paragraph 25, FinREC believes securities underwriting transactions generally do not meet any of the requirements for revenue to be recognized over time. Therefore, a broker-dealer would generally recognize securities underwriting revenue at a point in time.

27. FASB ASC 606-10-25-30 provides indicators for determining the point in time when the issuer obtains control of the securities underwriting services and the broker-dealer's performance obligation is satisfied, which include the following [analysis added]:

    a. The entity has a present right to payment for the asset (i.e., the service).

       A broker-dealer has a present right to payment, in the form of the underwriting spread which occurs on the trade date. Trade date is the date the broker-dealer enters into a firm commitment to purchase the securities from the issuer, or in the case of a best efforts arrangement, the date the securities are sold to investors.

    b. The customer has legal title to the asset (i.e., the service).

       The issuer has legal title to the capital raised (i.e., the underwriting proceeds), which is a result of the consummation of the underwriting services provided, upon the purchase of the securities from the issuer, which occurs on the trade date.

    c. The entity has transferred physical possession of the asset (i.e., the service).

Not applicable as underwriting services do not involve the transfer of a physical asset.

d. The customer has the significant risks and rewards of ownership of the asset (i.e., the service).

The issuer has the significant risks and rewards of the securities underwriting services when those securities are purchased by the underwriter (i.e., the trade date). That is, the issuer is entitled to the capital raised and the issuer may also incur certain obligations to the investors (e.g., principal and interest payments to bond holders or dividends to preferred stock holders) on the trade date.

e. The customer has accepted the asset (i.e., the service).

Although generally there are no acceptance provisions in underwriting agreements, the services are satisfied when the underwriter purchases the securities from the issuer (i.e., the trade date).

28. Based upon the analysis in paragraph 27, FinREC believes the date on which the underwriter purchases securities (trade date) from the issuer is the appropriate point in time to recognize revenue for securities underwriting transactions. This conclusion is consistent with the concept of transfer of control related to commission revenues (as discussed in Issue #3-1A: Commission Income – Trade Date vs. Settlement Date) whereby control is transferred on trade date. In an underwriting arrangement there are no significant actions that an underwriter takes subsequent to the trade date.

29. The following example is meant to be illustrative, and the actual application of the guidance in FASB ASC 606 should be based on the facts and circumstances of an entity's specific situation.

Example:

Broker-dealer A negotiates a contract with Customer B on April 1, 20XX to underwrite Customer B's equity shares on a firm commitment basis. The offering consists of 6,000,000 equity shares and provides Broker-dealer A with an over-allotment option to purchase up to an additional 900,000 shares within 30 days of the equity offering. The initial offering price to the public is $20 and the underwriting discount is $.50 (i.e., the underwriter purchases the equity shares from Customer B for $19.50 per share). On April 8, 20XX the underwriting contract is executed and becomes legally enforceable. In connection with the execution of contract, Broker dealer A purchases the equity shares from the issuer (i.e., the trade date) resulting in the consummation of the securities issuance. Broker-deal A also elected to exercise its over-allotment option and purchases an additional 900,000 shares from the issuer on April 8, 20X6.

Identify the contract with a customer

Based on the facts above, the underwriting agreement between Broker-dealer A and Customer B includes a contract that meets the criteria in FASB ASC 606-10-25-1. The underwriting agreement has been approved, each party's rights and payment terms are identifiable, the contract contains commercial substance and collectibility is probable on April 8, 20XX.

Identify the performance obligations

Based on the facts above, the contract includes a single performance obligation to raise capital for Customer B. The over-allotment option was exercised and issued concurrently with the contractually required shares resulting in a contract modification. Therefore, Broker-dealer A has the enforceable rights and obligations to purchase the over-allotment securities on April 8, 20XX. The over-allotment securities are included in the example herein.

Determine the transaction price

Based on the facts above, the transaction price is calculated as the underwriting discount amount of $3,450,000 (6,900,000 shares x $.50).

Allocate the transaction price to the performance obligations

The transaction price of $3,450,000 is allocated to the single performance obligation.

Recognize revenue

Broker-dealer A would recognize underwriting revenue in the amount of $3,450,000 on April 8, 20X6, which is the date Broker-dealer A raised capital on behalf of the issuer.

Comments should be received by January 2, 2018, and sent by electronic mail to Ivory Bare at ivory.bare@aicpa-cima.com, or you can send them by mail to Ivory Bare, Product Management and Development, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.