



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

May 2, 2016

James L. Kroeker, Vice Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Vice Chairman Kroeker:

I am writing with regard to the Securities and Exchange Commission (SEC) staff's long-standing guidance relevant to an evaluation of whether carried interest arrangements are permitted to be viewed as financial instruments. The subject of this letter arises in the context of a discussion at the FASB's Revenue Recognition Transition Resource Group (TRG) meeting on April 18, 2016 regarding the application of the scoping guidance in the new revenue recognition standard to carried interest arrangements.¹ The SEC staff is concerned that the description of the SEC staff's long-standing views by certain TRG members during the meeting was inconsistent with the SEC staff's guidance.

For background, carried interest arrangements arise in partnerships established to facilitate owning and managing financial assets, non-financial assets, businesses, or some combination thereof. The arrangements for purposes of this letter are documented within a limited liability partnership agreement that forms a limited partnership; provide the general partner a right to an allocation of the limited partnership's net earnings (whether positive or negative), disproportionate to the amount allocated to limited partners; and require that such allocations be recorded by the partnership within the partnership capital accounts with balances, if any, subject to the partnership's performance and operating risks.

The scoping guidance in the new revenue recognition standard² states, in relevant part³:

"An entity shall apply the guidance in this Topic to all contracts with customers, **except** the following:

...

c. **Financial instruments** and other contractual rights or obligations **within** the scope of the following Topics:

...

3. **Topic 323, Investments—Equity Method and Joint Ventures....**"⁴

¹ TRG paper 50, *Scoping Considerations for Incentive-based Capital Allocations, Such as Carried Interest*.

² Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers*.

³ Throughout this letter, emphasis in bold was added to the quoted references.

⁴ ASC 606-10-15-2

The ASC Master Glossary defines a financial instrument to include “cash, **evidence of an ownership interest** in a company or other entity....” ASC Topic 323 states that:

“The equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles (GAAP) in the economic resources underlying the investments. ...

The equity method tends to be most appropriate if an investment enables the investor to influence the operating or financial decisions of the investee. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee....”⁵

The SEC staff has long-standing guidance with respect to ownership interests in limited partnerships. In May 1995, the Staff issued EITF Topic No. D-46, *Accounting for Limited Partnership Investments* (Topic D-46), which states:

“The SEC staff’s position on the application of the equity method to investments in limited partnerships is that **investments in all limited partnerships should be accounted for pursuant to paragraph 970-323-25-6. That guidance requires the use of the equity method** unless the investor’s interest ‘is so minor that the limited partner may have **virtually no influence** over partnership operating and financial policies.’ The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor.”

Consistent with Topic D-46, the SEC staff has interpreted that the application of the equity method is appropriate to interests in limited partnerships, including the general partner’s interest, provided that such interest provides more than minor influence over the partnership’s operating and financial policies. Therefore, we would anticipate that the equity method of accounting would generally apply to the general partner interest. While Topic D-46 provided guidance on the application of the equity method to investments in limited partnerships, it did not specifically address the allocation of the limited partnership’s net earnings to the general partner.

In 2001, questions were raised by constituents as to how to account for incentive allocations, which would include carried interest arrangements. In addressing those questions, the SEC staff issued EITF Topic No. D-96, *Accounting for Management Fees Based on a Formula* (Topic D-96), which states at footnote 1:

“The SEC staff understands that in certain entities within the scope of AICPA Statement of Position No. 78-9, *Accounting for Investments in Real Estate Ventures*, the manager is the general partner in a partnership and **receives fees in the form of partnership allocations**. If the general partner manager has been **accounting for such arrangements on the equity method** in accordance with that SOP, **the manager may continue to apply that method.**”

⁵ ASC 323-10-05-4 through 05-5

For the sake of clarity, the guidance above would not apply if a reporting entity is required to consolidate the limited partnership under ASC Topic 810, *Consolidation*.

Please contact Wes Bricker, Deputy Chief Accountant, Office of the Chief Accountant, at 202-551-3014 with any questions regarding this letter.

Sincerely,

A handwritten signature in black ink, appearing to read 'Wesley R. Bricker', with a long horizontal flourish extending to the right.

Wesley R. Bricker
Deputy Chief Accountant

cc: Members of the Revenue Recognition Transition Resource Group
Members of the Financial Accounting Standards Board
Public Company Accounting Oversight Board Observer