

## Case 94-8

### **Making Money the Old-Fashioned Way**

Bears & Bulls Inc. (BB) is an investment advisor to two investment partnerships, Turnaround Management (TM) and Friendly Partners (FP) and to a pension plan (the Plan). BB's advisory relationship with each is described below.

#### *The Investment Partnerships*

BB is a 1% general partner in TM. TM raises capital to invest in troubled companies to gain a position of influence in the target so as to turn it around and realize the appreciation. BB's allocated portion of TM's earnings has three components: (1) a one percent equity interest in the earnings of TM, (2) a management fee, and (3) an incentive fee.

FP also invests in troubled companies, principally in the media industry, with objectives similar to TM. BB has no equity ownership in FP. As advisor, BB receives compensation in the form of (1) a management fee and (2) an incentive fee.

TM and FP record investments on a mark-to-market basis in accordance with the AICPA Audit and Accounting Guide, *Audits of Investment Companies*. Accordingly, TM and FP recognize unrealized gains/losses on investments as a component of current income/loss.

The incentive fee paid to BB by both TM and FP is based on a fixed percentage of the respective partnership's cumulative net realized gains on investments. Incentive fees earned to date are subject to repayment in the event of future net realized losses. There is no incentive fee with regard to net cumulative realized losses. Upon termination of either the partnership or the incentive fee agreements, unrealized gains and losses will be considered to be realized for purposes of the incentive fee computation.

BB recognizes the incentive fee income from TM and FP based on the payment terms of the respective agreements, that is, as gains and losses are realized. BB discloses, as a contingent liability, that the incentive fees earned to date are subject to repayment in the event of future realized losses.

#### *The Plan*

BB manages the international investments of the Plan. BB receives investment advisory fees from the Plan, based on a percentage of assets managed, as well as an incentive fee based on the performance of funds managed by BB relative to an "international index." The index is prepared for the Plan by an independent brokerage firm. The index blends the performance of stock exchanges in Europe, North America and the Pacific Rim. The incentive fee is based on performance of managed funds for each fiscal year ended June 30th, the advisory contract's year end. BB's year end for financial reporting purposes is December 31. Incentive fees received are nonrefundable. In the event the contract is terminated, the incentive fee is computed on a pro rata basis for the performance of the fund relative to the independently determined international index for the contract year-to-date.

At December 31, 19X0, BB accrued incentive fee income based on the pro rata performance of the managed funds relative to the index for the contract year-to-date. In the succeeding six months, the fund's performance relative to the index declined, reducing the final incentive fee paid to BB for the contract year to an amount less than the balance accrued by BB at December 31, 19X0. Additionally, at June 30, 19X1, the Plan notified BB that the investment broker had made an error in the computation of the index for the prior periods of the 19X1 contract year and provided BB a revised index. The revised index caused BB's incentive fee for the contract year to decline even further.

**Required:**

- How should BB account for the incentive fees under the advisory agreements with TM, FP and the Plan?
- How should BB account for the adjustment to the fee accrued for the Plan that is related to the independent broker's error in computing the international index for the year ended December 31, 19X0?