Regulatory Notice 23-21

FINRA Reminds Member Firms of Net Capital, Recordkeeping and Financial Reporting Requirements in Connection with Revenue Recognition Practices

December 22, 2023

Notice Type
- Guidance

Suggested Routing
- Compliance
- Finance
- Legal
- Operations
- Regulatory Reporting
- Senior Management

Key Topics
- Annual Reports
- FOCUS Reporting
- U.S. Generally Accepted Accounting Principles ("US GAAP")
- Revenue Recognition
- Supplemental Statement of Income ("SSOI")

Referenced Rules & Notices
- SEA Rule 15c3-1
- SEA Rule 17a-3
- SEA Rule 17a-5
- SEA Rule 17a-11
- FASB ASC 606
- FINRA Rule 4110
- FINRA Rule 4524

Summary

Through its examinations of member firms, FINRA has observed instances of non-compliance with SEA Rule 15c3-1, SEA Rule 17a-3 and SEA Rule 17a-5 resulting from misapplication of the Financial Accounting Standards Board's *Accounting Standard Codification 606, Revenue from Contracts with Customers* ("ASC 606"). This *Notice* provides guidance regarding potential compliance issues with respect to these rules that may result from the misapplication of ASC 606.

Questions regarding this *Notice* should be directed to:

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Background & Discussion

Under SEA Rule 15c3-1, a firm's net worth must be computed in accordance with US GAAP.[1] In computing net worth, US GAAP requires firms to recognize their revenue from contracts with customers in accordance with ASC 606, when applicable.[2] Broadly, ASC 606 provides that when consideration is received by the firm before the related performance obligation under the contract has been satisfied, whether at a point in time or over time, the consideration is recognized as a liability, not as revenue. Thus, revenue recognition by a firm should occur when the related performance obligation has been satisfied, either at a point in time or over time, depending on the contract terms.

FINRA examination staff have observed certain practices in firms' application of ASC 606 in accounting for revenues from contracts with customers. For example:

- Firms entered a contract with a customer to provide merger and acquisition services and received a non-refundable fee upon entering the contract. The firms recognized revenue for the full amount of the fees received at the time they signed the contract, prior to satisfying the related performance obligation. Further, firms could not demonstrate that they had performed the analysis required by ASC 606 to determine the proper timing of revenue recognition and could not substantiate that they had satisfied their performance obligation under the contract at a point in time or over time.
- Firms entered a contract with a customer to provide merger and acquisition services and began receiving monthly non-refundable fees under the contract. The firms recognized revenue upon receipt of such fees each month, even though they had not satisfied the related performance obligation under the contract over time or at a point in time. Further, firms could not demonstrate that they had performed the analysis required by ASC 606 to determine the proper timing of revenue recognition and could not substantiate that they had satisfied their performance obligation under the contract at a point in time or over time.

Recognizing non-refundable fees received from customers as revenue upon entering the contract and receiving payment, based solely upon a non-refundable clause in the contract, or recognition of non-refundable fees received throughout the term of a contract as revenue, without substantiating that the related performance obligation has been satisfied or has been satisfied over time, generally would not be sufficient substantiation of the analysis required by ASC 606 to determine the proper timing of revenue recognition. The foregoing practices resulted in firms overstating their revenues and understating their non-allowable assets and liabilities. In some cases, this resulted in net capital deficiencies or a material reduction in the firms' reported excess net capital. These firms also did not comply with SEA Rules 17a-3(a)(2) and 17a-3(a)(11), which broadly require firms to make and keep current records relating to their ledgers reflecting all assets and liabilities, income and expense, and capital accounts, and to make and keep current records of their computation of aggregate indebtedness and net capital. Further, the firms did not comply with SEA Rule 17a-5, pursuant to which they must file FOCUS reports[3] and annual reports[4] consistent with all applicable requirements.

To substantiate their compliance with ASC 606 in recognizing revenue from contracts with customers, firms should ensure that they are able to demonstrate, through a documented policy and analysis that is applied consistently, the basis for their revenue recognition practices, in accordance with the requirements of ASC 606. Specifically, firms should analyze each contract with their customers for the performance obligation(s) thereunder and the revenue associated with each such obligation, and document when and how such performance obligation(s) has been satisfied.

Further, firms should ensure that their annual reports are prepared in accordance with SEA Rule 17a-5 and include appropriate footnote disclosures required by ASC 606.[5] Additionally, revenue reported on the FOCUS report required to be filed under SEA Rule 17a-5, as well as on the Supplemental Statement of Income required to be filed under FINRA Rule 4524, should be reported in accordance with ASC 606 and be consistent with the revenue recognition disclosures made in the firm's annual report.

Endnotes

1 *See* SEA Rule 15c3-1(c)(2)/01 Generally Accepted Accounting Principles (GAAP) in the Interpretations to the SEC's Financial and Operational Rules. Generally, net capital is computed by adding net worth and any subordinated debt, and deducting assets that are not readily convertible into cash and specified other items.

2 *See* ASC 606 (including in particular ASC 606-10-05-3 and ASC 606-10-05-4).

3 *See* the General Instructions of the FOCUS Report Part IIA or FOCUS Report Part II.

4 *See* SEA Rule 17a-5(d)(2)(i).

5 *See* ASC 606-10-50 for specific ASC 606 disclosure requirements.